No. 921

FILED
APR 17 1957
JOHN T. FEY, Clerk

In the Supreme Court of the United States

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

P. G. LAKE, INC.

FRANK SCHOFIELD, JUDSON COLLECTOR OF INTERNAL REVENUE, PETITIONER,

v.

DENNIS M. O'CONNOR AND KATHERINE O'CONNOR, INDEPENDENT EXECUTORS OF THE ESTATE OF THOMAS O'CONNOR, DECEASED, AND DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAGAN, JOINED BY HER HUSBAND, D. H. BRAGAN, AND THOMAS O'CONNOR, JR.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

WM. FLEMING AND BESSIE M. FLEMING, HUSBAND AND WIFE, J. HOWARD WALSH AND MARY D. WALSH, HUSBAND AND WIFE, AND MARY D. FLEMING WALSH.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

JOHN WEATHERLY AND NELL WEATHERLY, HUSBAND AND WIFE.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

W. T. WELD, INDIVIDUALLY, AND ESTATE OF ELEANOR M. WELD, DECEASED, W. T. WELD, EXECUTOR.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

J. LEE RANKIN,
Solicitor General,

CHARLES K. RICE,
Assistant Attorney General,

HILBERT P. ZARKY,
MELVA M. GRANEY,
Attorneys,
Department of Justice,
Washington 25, D. C.

INDEX

	Page
Opinions below	2
Jurisdiction	2
Questions presented	3
Statute and Regulations involved	3
Statement	3
Reasons for granting the writ	11
Conclusion	21
Appendix A	22
Appendix B	
Trial Court Opinions	
Lake	28
O'Connor (Findings of Fact and Conclusions of Law)	30
Fleming	56
Wrather	63
Weed	77
Court of Appeals Opinions	
Lake	69
O'Connor	83
Fleming	94
Wrather	102
Weed	104
Court of Appeals Judgments	107

CITATIONS

Cases:

Anderson v. Helvering, 310 U. S. 404	4
Barnet v. Hormel, 287 U. S. 103	12, 14, 17, 18
Caldwell v. Campbell, 218 F. 2d 567	4, 13, 20
Commissioner v. Bacon, 231 F. 2d 340	4, 20
Commissioner v. Slagter, 238 F. 2d 901	4, 12, 16
Commissioner v. Sunnen, 333 U. S. 591	12, 15
Corn Products Co. v. Commissioner, 350 U. S. 46, rehearing denied, 350 U. S. 943	12, 14, 17
Fisher v. Commissioner, 209 F. 2d 513, certiorari denied, 347 U. S. 1014	19
Harrison v. Schaffner, 312 U. S. 579	12, 15
Hays v. Commissioner, 23 T. C. 546	4

Cases Continued — Page

Healy v. Commissioner, 345 U. S. 278 — 13
Helvering v. Clifford, 309 U. S. 331 — 12, 15
Helvering v. Horst, 311 U. S. 112 — 12
Helvering v. Smith, 90 F. 2d 590 — 19
Hort v. Commissioner, 313 U. S. 28 — 13, 14, 18
Hulbert v. Commissioner, 227 F. 2d 599 — 19
Jordan v. Commissioner, 22 T. C. 1132 — 4
North American Oil v. Burnet, 286 U. S. 417 — 15
Palmer v. Bender, 287 U. S. 551 — 19
Rhodes' Estate v. Commissioner, 131 F. 2d 50 — 19
Slater v. Commissioner, 24 T. C. 935 — 4
Tennant, Receiver v. Dunn, 130 Tex. 285 — 14
Thomas v. Perkins, 301 U. S. 655 — 19
United States v. Sorg, 223 F. 2d 103, certiorari denied, 350 U. S. 831 — 19
Watson v. Commissioner, 345 U. S. 544, rehearing denied, 345 U. S. 100 — 13, 14

Internal Revenue Code of 1939

sec. 22(a) (26 U. S. C. 1952 ed., Sec. 22(a)) — 22
Sec. 112(a) (26 U. S. C. 1952 ed., Sec. 112(a)) — 22
Sec. 112(b) (26 U. S. C. 1952 ed., Sec. 112(b)) — 7, 22
Sec. 117 (26 U. S. C. 1952 ed., Sec. 117) — 4, 7, 14, 18, 23
Sec. 117(a) (26 U. S. C. 1952 ed., Sec. 117(a)) — 23
Sec. 117(b) (26 U. S. C. 1952 ed., Sec. 117(b)) — 24
Sec. 117(j) (26 U. S. C. 1952 ed., Sec. 117(j)) — 24
Sec. 272(a)(1) (26 U. S. C. 1952 ed., Sec. 272(a)(1)) — 3

Miscellaneous

Brewster and Bunyon, *Taxation of Oil and Gas Income*, Sec. 2.04 (1954) — 3
G. C. M. 24849, 1946-1 Cum. Bull. 60 — 20
I. T. 4003, 1950-1 Cum. Bull. 10 — 20
32 Taxes, Tax Magazine 494, 496 (1954) — 21

Treasury Regulations 111

Sec. 29.112(a)-1 — 25
Sec. 29.112(b)(1)-1 — 27

Welsch, *Tax Aspects of Owning and Disposing of Interests in Oil and Gas*, 31 Taxes, Tax Magazine 855 (1953) — 5

In the Supreme Court of the United States

OCTOBER TERM, 1956

Nos.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

P. G. LAKE, INC.

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

DENNIS M. O'CONNOR AND KATHERINE O'CONNOR, INDEPENDENT EXECUTORS OF THE ESTATE OF THOMAS O'CONNOR, DECEASED, AND DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, JOINED BY HER HUSBAND, D. H. BRAMAN, AND THOMAS O'CONNOR, JR.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WM. FLEMING AND BESSIE M. FLEMING, HUSBAND AND WIFE, F. HOWARD WALSH AND MARY D. WALSH, HUSBAND AND WIFE, AND MARY D. FLEMING WALSH

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN WEATHER AND NELL WEATHER, HUSBAND AND WIFE

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

W. F. WEED, INDIVIDUAL, AND ESTATE OF ELEANOR M. WEED, DECEASED, W. F. WEED, EXECUTOR

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue and Frank Scofield, former Collector of Internal Revenue, prays that writs of certiorari issue to review the judgments of the Court of Appeals for the Fifth Circuit in the above-entitled cases, which, although entirely separate proceedings,

involve the same ultimate question and were decided by the court below on the same day after having been argued *seriatim* before the same panel of judges. (See Rule 23 (5) of the Revised Rules of this Court.)

OPINIONS BELOW

The opinion of the Tax Court in the *Lee* case (Appendix B, *infra*, pp. 28-30) is reported at 24 T. C. 1016. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 69-83) is not as yet reported.

The findings of fact and conclusions of law of the District Court in the *O'Connor* case (Appendix B, *infra*, pp. 30-35) are reported at 143 F. Supp. 240. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 83-90) is not as yet reported.

The findings of fact and opinion of the Tax Court in the *Fleming* case (Appendix B, *infra*, pp. 36-53) are reported at 24 T. C. 818. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 91-101) is not as yet reported.

The memorandum findings of fact and opinion of the Tax Court in the *Wyatt* case (Appendix B, *infra*, pp. 53-56) are not officially reported. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 102-103) is not as yet reported.

The findings of fact and opinion of the Tax Court in the *Wood* case (Appendix B, *infra*, pp. 57-68) are reported at 24 T. C. 1025. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 104-107) is not as yet reported.

JURISDICTION

The judgments of the Court of Appeals in all five cases were entered on February 1, 1957. (Appendix B, *infra*, pp. 107 *et seq.*) The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

All five cases present the following general question:

Whether the consideration received for the so-called sale or exchange of an oil (or sulphur) payment right is taxable as ordinary income subject to depletion, as the Government contends, or as capital gain under Section 117 of the Internal Revenue Code of 1939, as the court below held.

The *Fleming* case presents the following additional related question:

Whether the court below erred in holding that the so-called exchanges of oil payment rights for fee simple interests in real estate constitute tax-free exchanges of property of like kind within the meaning of Section 112(b)(1) of the 1939 Code.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in Appendix A, *infra*, pp. 22-27. They are as follows: Sections 22(a), 112(a) and (b)(1), 117(a)(1) and (4), (b), and (j)(1)(2), of the 1939 Code, and Sections 29.112(a)-1 and 29.112(b)(1)-1 of Treasury Regulations 111.

STATEMENT

The *Lake*, *Fleming*, *Wrather*, and *Wood* cases involve deficiencies in income tax and originated in the Tax Court by the filing of petitions for review pursuant to Section 272(a)(1) of the Internal Revenue Code of 1939. The *O'Connor* case is a suit for refund of income taxes filed in a district court pursuant to 28 U.S.C., Section 1340. In all five cases, the controversy is with respect to the proper treatment, for income tax pur-

poses, of one or more so-called sales or exchanges of oil (or sulphur) payment rights.[1]

The lower courts held that the transactions constituted sales, and in the *Fleming* case exchanges, of a capital asset within the meaning of Section 117 of the Internal Revenue Code of 1939 rather than, as the Government contended, assignments of future income. (Appendix B, *infra*, pp. 28-68.)[2] In all five cases, the Fifth Circuit affirmed the lower court. (Appendix B, *infra*, pp. 69-107.)

The following is a summary of the basic facts in each case:

Lake case

P. G. Lake, Inc. (hereinafter called the corporation or the taxpayer-corporation) is a Delaware corporation with its principal office in Tyler, Texas. It is engaged in the business of producing oil and gas and

[1] "An 'oil payment' or 'oil payment right' is the right to a specified sum of money payable out of a specified percentage of the oil or the proceeds received from the sale of such oil if, as and when produced." *Anderson v. Helvering*, 310 U.S. 404, 410. The right is free and clear of the costs and expenses of production and in that respect is similar to a royalty interest which, however, is "a right to receive a specified percentage of all oil and gas produced during the term of the lease." *Anderson v. Helvering*, *supra*, p. 409.

[2] In each of the four cases which originated in the Tax Court, *Lake*, *Fleming*, *Wrather*, and *Weed*, the Tax Court's decision was based upon the Fifth Circuit's decision in *Caldwell v. Campbell*, 218 F. 2d 567, and the Tax Court's own decision in *Hazen v. Commissioner*, 23 T.C. 546, which was subsequently reversed by the Fifth Circuit *(Commissioner v. Hazen*, 231 F. 2d 340). In the *Weed* case, the Tax Court also relied upon its own decision in *Slagter v. Commissioner*, 24 T.C. 935, which was subsequently reversed by the Seventh Circuit *(Commissioner v. Slagter*, 238 F. 2d 901). In all four cases, the Tax Court also relied upon its own decision in *Nichols v. Commissioner*, 22 T.C. 1132, which, however, involved the gift tax rather than the income tax. In the fifth case *(O'Connor)*, the District Court wrote no opinion.

on December 29, 1950, owned the 7½ working interest in two commercial oil and gas leases covering land in Texas, the Reid and Owens Leases, from which it, as the operator, was then producing oil in substantial quantities. (Appendix B, *infra*, p. 29; Stip., *Lake* R. 31.)

Being indebted to its president, P. G. Lake, in the sum of $600,000, the taxpayer-corporation on December 29, 1950, assigned to its president, in consideration of the cancellation of the $600,000 indebtedness, an oil payment right in the amount of $900,000 plus an amount equal to interest at 3 per cent per annum on the unpaid balance remaining from month to month, payable out of 25 per cent of the oil attributable to the corporation's working interest in the Reid and Owens Leases. On the date of the assignment, it could have been estimated with reasonable accuracy that the assigned oil payment right would require three or more years to pay out. The actual pay-out period was from January 1951, to February 1954, a little over 3 years. (Appendix B, *infra*, p. 29; Stip., *Lake* R. 31-33.)

O'Connor case

In this case, the so-called sale of an oil payment right was made by the executors, heirs, and devisees of the estate of Thomas O'Connor for the purpose of raising money to pay federal estate taxes, state inheritance taxes, and administration expenses. In the fiduciary income tax returns filed by the executors for the fiscal period ended November 30, 1948, the proceeds from the so-called sale were reported as ordinary income subject

[1] The "working interest" is the name commonly given to the leasehold interest and is the entire mineral interest less the royalty interest customarily retained by the lessor. See Brooding and Burton, *Taxation of Oil and Gas Income*, Sec. 2.04 (1954); Welsch, *Tax Aspects of Owning and Disposing of Interests in Oil and Gas*, 31 Taxes, Tax Magazine 855 (1953).

APPENDIX A

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(1) *Property held for productive use or investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or

to depletion, but claims for refund were subsequently filed on the ground that the proceeds should have been reported as capital gain. The claims for refund were denied, and this suit for refund followed. (Appendix B, *infra*, pp. 31, 33, 34.)

The so-called sale of the oil payment right was made by the estate on November 26, 1948, as the owner of eight oil royalty interests which the decedent, who died in 1946, had reserved in 1934 in executing oil and gas leases on property owned by him. (*O'Connor* R. 16-21, 48-49.) The sale was to D. C. Blackburn, the president of a bank of whose stock 12 per cent was owned by the O'Connors (*O'Connor* R. 59, 60), and was of an oil payment right in the amount of $10,000,000 plus an amount equal to 4 per cent interest per annum on the unrealized balance thereof remaining from month to month, payable out of the oil attributable to the estate's eight royalty interests. For the oil payment assignment, Blackburn paid the estate $9,990,350 which he borrowed from the Chase National Bank in New York on his personal 36-month note, bearing 3½ per cent interest, without any security other than a deed of trust on the oil payment right he received from the estate. (Appendix B, *infra*, p. 31; *O'Connor* R. 58, 60, 69-70.) Before making the loan, the Chase National Bank in New York sent its own engineers down to Texas to value the properties and received their approval of the collateral (the oil payment right). (*O'Connor* R. 61-62.)

On the date of the oil payment assignment, it could be estimated from available information that pay-out of the assigned oil payment right would take about 4,000,000 barrels of the 23,150,000 barrels of oil in place, attributable to the royalty interests (or about 17 per

cent). The assigned oil payment right paid out in 3 years. (*O'Connor* R. 32, 71.)

Fleming case

This case involves oil payment assignments made in exchange for real estate. In their income tax returns, the taxpayers treated the transactions as tax-free exchanges of property of like kind within the meaning of Section 112(b)(1) of the 1939 Code, reporting no income at all from the transactions. The Commissioner determined deficiencies on the ground that the transactions were not tax-free and that the income therefrom was taxable as ordinary income subject to depletion. The Tax Court held that the transactions were not exchanges of property of like kind so as to be tax free under Section 112(b)(1), but held that the income from the transactions was taxable as capital gain rather than as ordinary income subject to depletion. (Appendix B, *infra*, pp. 45-50, 53.) On cross-appeals to the Fifth Circuit, that court held that the transactions are not taxable at all under Section 112(b)(1) but that, if such a view is erroneous, the income from the transactions is taxable as capital gain under Section 117 of the 1939 Code. (Appendix B, *infra*, pp. 91-98.)

Two so-called exchanges are involved. The first one (see Appendix B, *infra*, pp. 37-45) was made on May 19, 1948, and consisted of separate oil payment assignments by three related parties—William Fleming individually, a partnership in which he and a trust were the partners, and the trust—for undivided fee simple interests in a ranch. Four oil payment assignments were made, one by William Fleming individually, one by the partnership, and two by the trust. Three were made by the assignors as owners of leasehold interests

extent such gain is taken into account in computing net income;

* * * * *

(b) [as amended by Sec 150(c) of the Revenue Act of 1942, *supra*] *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;
50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(j) [as added by Sec 151(b) of the Revenue Act of 1942, *supra*] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in

and the other as the owner of a royalty interest. All of those interests were held by the assignors for productive use in their respective businesses of producing oil. The oil payment assignments varied as to amount, estimated pay-out period, and the percentage of the assignor's interest out of which they were payable. However, as to each assignor, the oil payment assignment or assignments was in an amount which represented the fair market value of the undivided interest in the ranch received by such assignor, plus an amount equal to a specified percentage of interest per annum on the balance thereof remaining unpaid from time to time.[4]

The other so called exchange (see Appendix B, *infra*, pp. 50-53) consists of an oil payment assignment by taxpayer F. Howard Walsh, as the owner of oil and gas leasehold interests held by him for productive use in his business of producing oil, for the fee simple title to business real estate in Fort Worth, Texas. The oil payment assignment was in the amount of $865,000 (the fair market value of the real estate received (see *Fleming* R. 117, 119)), plus 7 per cent interest per annum on the unpaid balance thereof remaining unpaid from time to time, and was payable only out of fractional parts of the assignor's interests in several leases. The estimated pay-out period for the assigned oil payment right was about 3 years.

Wrather case

Like the *Lake* and *Fleming* cases, this case involves oil payment assignments by a leasehold owner. Taxpayer John Wrather was a member of a partnership

[4] This is shown by a comparison of the face amount of the oil payment assignments (Appendix B, *infra*, pp. 38-43) with the Commissioner's uncontested determinations of fair market value (*id.* p. 44).

which owned a number of oil and gas leasehold interests, including an undivided 7/24 leasehold, or "working", interest in the Brown Lease on land located in Illinois and an undivided 5/16 leasehold interest in the Kieffer "A" Lease on land located in Indiana. Both of the latter interests were held by the partnership for the development and production of oil and gas. (Appendix B, *infra*, pp. 54-55.)

In 1948 the partners made three so-called sales to the Indiana Farm Bureau Cooperative Association, Inc. (hereinafter called the Cooperative) of oil payment rights payable out of the production under the Brown and Kieffer "A" Leases. Even in form, however, each transaction involved only an "Oil Payment Agreement" (Ex. J-10, not printed) which stated simply that the Cooperative "shall be paid" a specified sum "out of the oil produced and saved", to the extent of a specified portion, until the full specified sum shall have been paid to Cooperative. The following are the other pertinent facts relating to each oil payment assignment (Appendix B *infra*, pp. 54-55):

Brown Lease	
Date	June 19, 1948
Amount	$130,000
Consideration	$125,000
Payable out of 9/10 of oil attributable to assignor's leasehold interest	
Estimated pay-out period	4 to 6 years
Actual pay-out period	4 years
Kieffer "A" Lease	
(1) Date	June 19, 1948
Amount	$155,000
Payable out of 9/10 of oil attributable to assignor's leasehold interest	
(2) Date	August 16, 1948
Amount	$12,500
Payable out of 9/10 of oil attributable to assignor's leasehold interest	
Total consideration for the two assignments	$162,500
Estimated pay-out period for both assignments	4 to 6 years
Actual pay-out period for both assignments	3 years and 5 months (from first assignment)

Weed case

Here the so-called sale was of a sulphur, instead of an oil, payment right. The taxpayer was the owner of a pooled or entirety royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land referred to as Boling Dome, in Wharton County, Texas. The royalty interest entitled taxpayer to receive $0.0390625 per long ton of sulphur produced from Boling Dome by the aforementioned company, irrespective of what the market price for such sulphur might be. (Appendix B, *infra*, pp. 59-60.)

On December 21, 1947, taxpayer assigned to Marion Munro a sulphur payment consisting of $0.254511 per cent of the pooled royalty interest (*i.e.*, $0.0099609375 per long ton on 6,000,000 long tons of the remaining 24,000,000 long tons of sulphur to be produced from Boling Dome). For the sulphur payment assignment, Munro gave taxpayer

Check dated 12-21-47	$15,000
Promissory note due 12-21-48 with interest after maturity	10,500
Promissory note due 12-21-49 with interest after maturity	10,500
	$36,000

Munro obtained the purchase money by loans from a bank, as security for which he used the sulphur payment. The assigned sulphur payment paid out in 28 months. Receipt of royalty checks by Munro under the sulphur payment made it unnecessary for him to borrow more than $11,500 in order to pay the $15,000 note due taxpayer. (Appendix B, *infra*, pp. 61-64.)

The sulphur payment assignment was preceded by discussions between taxpayer and Munro, the assignee,

a C.P.A. who was then retained by two of taxpayer's corporations and who subsequently prepared taxpayer's individual joint income tax returns for 1948 and 1949. Taking into account various considerations, including tax savings to taxpayer and the amount of annual royalty payments which Munro would probably receive, it was agreed that the sulphur payment assignment would be based upon taxpayer's anticipated requirements for funds to pay taxes for the succeeding three years and upon a four year pay out period to Munro from sulphur production. Munro advised taxpayer that the latter's tax saving from the transaction would be about $1,000 to $1,500 and Munro estimated that his own profit from the transaction (after allowance for the discount factor) would approach $2,000. (Appendix B, *infra*, pp. 60-61.)

REASONS FOR GRANTING THE WRIT

Each taxpayer here, as the owner of an interest in mineral properties, would normally realize income as the minerals are produced and sold, and the balance of that income (after deduction of the statutory allowance for depletion) would be taxed to them at ordinary income rates. However (by a method peculiarly available in the natural resources industry), these taxpayers made a temporary transfer of a portion of their rights, for a lump sum consideration; as a result, for a relatively short period of time, the transferees of these rights become entitled to collect the income which the taxpayers would otherwise have collected. The taxpayers contend, merely because of this temporary transfer, that they are entitled to preferential capital gain treatment on this lump sum consideration even

though it is, in effect, only a substitute for the income which they would otherwise have collected in the future. The Court of Appeals, in upholding the taxpayers' contention, has reached a conclusion which is in conflict with the decisions of this Court and other Courts of Appeals, and which raises important and substantial questions in the administration of the revenue laws.

1. The decisions below are in direct conflict with the recent decision of the Seventh Circuit in *Commissioner v. Slagter*, 238 F. 2d 901, where, under analogous circumstances, it was held that the taxpayers realized ordinary income rather than capital gain. The decisions below are also in conflict, in principle, with the following decisions of this Court: *Burnet v. Harmel*, 287 U.S. 103; *Corn Products Co. v. Commissioner*, 350 U.S. 46; *Watson v. Commissioner*, 345 U.S. 544; *Hort v. Commissioner*, 313 U.S. 28; *Harrison v. Schaffner*, 312 U.S. 579; *Helvering v. Horst*, 311 U.S. 112; *Helvering v. Clifford*, 309 U.S. 331; *Commissioner v. Sunnen*, 333 U.S. 591. And the decisions in the present cases are also out of harmony with many decisions of the Courts of Appeals which have followed the principles declared by this Court in the above-cited cases.

In *Commissioner v. Slagter*, *supra*, the owners of the working interest in oil and gas leases transferred, for a lump sum consideration of $501,000, a portion of their interest which entitled the transferee to receive the sum of $513,500 from 60% of the transferors' share of the oil and gas which might be produced. The transferors undertook no personal obligation to make any part of the payments; the transferee could look only to future production of oil and gas from the leases; and the transferee's interest was to terminate when the speci-

fied sum had been recovered out of future production.[6] The transferee received the sum of $513,500, and its interest actually terminated within a period of 5 years and 3 months after the transfer.

The Tax Court in *Slaytor* (24 T.C. 935), following the lead of the Fifth Circuit,[7] had held that the lump sum consideration received by the transferors represented proceeds from the sale of a capital asset and that the gain was thus taxable to them as long-term capital gain. The Seventh Circuit reversed, holding that the gain was taxable to the transferors as ordinary income, to be taxed during the period when the oil proceeds were actually received by the transferee.[8] That court, rejecting the contention that local concepts of property law were germane in construing the federal taxing statute, held that the transfer of the oil payment right did not represent a "sale" of "capital assets" as Con-

[6] This arrangement is known in the industry as an "in-oil payment". See note 1, *supra*. Although different language is used in various instruments of transfer, the ultimate effect of these provisions is to entitle the holder of an oil payment right to receive a specified sum of money payable out of a stipulated portion of production of the wells in which the transferor has an interest, free and clear of any expenses of production. Once the holder of the oil payment right has received the specified sum, his interest ceases and the transferor has all the rights which he originally possessed prior to the transfer. Similar arrangements can be made with respect to other mineral interests, as in the *Weed* case, which involves a sulphur payment right.

[7] *Caldwell v. Campbell*, 218 F. 2d 567 (C.A. 5th).

[8] While we believe that the Seventh Circuit reached the correct conclusion on the *nature* of the income, it reached a doubtful result on the question of *when* the income was realized. See *Hort v. Commissioner*, 313 U.S. 28; *North American Oil v. Burnet*, 286 U.S. 417; *Healy v. Commissioner*, 345 U.S. 278. This point was not briefed or argued by the parties, both of whom assumed that the income, whatever its nature, was taxable in the year when the transferors received the lump sum consideration.

gress used those terms in Section 117 of the 1939 Code (Appendix A, *infra*, pp. 23-25). Instead, the Seventh Circuit, relying on a long line of decisions of this Court dealing with anticipatory assignments of income, concluded that the transfer was tantamount to an assignment, for a consideration, of future income, and held that the income realized by the transferors was taxable as ordinary income.

The decisions below stand in that contradiction to *Slaytor*. Unlike the Seventh Circuit, and in opposition to the decisions of this Court (*Burnet* v. *Harmel*, 287 U.S. 103, 110-111; *Watson* v. *Commissioner*, 345 U.S. 544, 551), the Fifth Circuit concluded that local property concepts were persuasive in ascertaining whether there has been a sale of "property" which would qualify for capital gain treatment under the federal taxing statute.[*] And, unlike the Seventh Circuit, and in opposition to this Court's holding regarding the fundamental legislative purpose of the capital gains provisions (see pp. 17-19, *infra*, and *Corn Products Co.* v. *Commis-*

[*] The Court of Appeals, in its emphasis on Texas law, placed heavy reliance on the decision in *Tennant, Rex* v. *Dunn*, 130 Tex. 285. Although we disagree with the conclusion of the court below that Texas law aids in answering the question of what "property" interests are capital assets under Code Section 117, it may be noted that in the *Dunn* case it was stated that the oil payment right there involved did not represent (p. 290) "a fractional interest in the entire leasehold estate". Within the framework of the issue presented in *Dunn*, the Texas Supreme Court held that the oil payment right represented an "interest in land" and the court below holds that this is "property" which is a capital asset under Section 117 of the federal taxing statute. In contrast stands this Court's statement in *Hort* v. *Commissioner*, *supra*, p. 31: "We assume that the lease was 'property,' whatever that signifies abstractly. * * * Simply because the lease was 'property' the amount received for its cancellation was not a return of capital, quite apart from the fact that 'property' and 'capital' are not necessarily synonymous in the Revenue Act of 1932 or in common usage."

sioner, 350 U.S. 46, 51-52), the court below refused to view the transfer as encompassing no more than a temporary disposition of the tranferors' rights to collect ordinary income; instead, it held that the right transferred amounted to a sale of property which was a sale of a capital asset under Code Section 117. In so holding, the court below departed from the basic principles, frequently applied by this Court, that amounts received as a substitute for rights to future income are not to be considered as capital gains (*Hort* v. *Commissioner*, 313 U.S. 28, 30-31) and that temporary assignments of rights to income are not to be considered as transfers of the income-producing property itself (*Harrison* v. *Schaffner*, 312 U.S. 579; *Helvering* v. *Horst*, 311 U.S. 112; *Helvering* v. *Clifford*, 309 U.S. 331; *Commissioner* v. *Sunnen*, 333 U.S. 591).

While there are factual differences among the cases decided by the court below, in their essential respects they are alike and are indistinguishable from *Slaytor*. In each case, the owner of an income-producing interest in mineral property transferred to another the right to collect, from a part of that interest, a limited amount of the income from the property. In each case, the transferor retained all other present rights in the property and regained all his rights as soon as the transferee had collected the full amount of the assigned income. For example, in the *O'Connor* case, the owner of royalty interests, for a cash consideration of $9,990,350, invested the transferee with the right to collect $10,000,000 (plus 4% per year on the monthly, unrealized balance) out of future production to which the royalty owner would otherwise have been entitled. The transferee, who collected the agreed amount during the ensuing three years and whose rights then terminated, was able to borrow

the "purchase price" from a bank on his personal note, secured only by the oil payment right, the bank, by its own geological survey, having first ascertained what was the estimated future production from the wells.[9] In the *Lake* case, the taxpayer corporation was the operator of oil and gas wells, having a $\frac{7}{8}$ working interest. To satisfy an indebtedness of $600,000 owing to its president, the corporation transferred to him the right to collect, out of the oil attributable to 25% of its $\frac{7}{8}$ interest in the leases, the amount of $600,000 (plus interest at 3% per year on the monthly unpaid balances). This amount was actually paid out during a period of approximately 3 years.

The significant facts of each of the cases decided by the court below can not be successfully distinguished from those involved in *Sluder*.[10] The decisions of these two Courts of Appeals, one permitting capital gains taxation and the other requiring taxation at ordinary income rates, are irreconcilable.[11]

[9] It was stipulated that there were approximately 23,150,000 barrels of recoverable oil under the properties and that approximately 19,150,000 barrels would remain after the $10,000,000 oil payment had been recovered.

[10] The court below (*Lake* opinion, Appendix B, *infra*, pp. 82-83) without giving any amplifying reasons, stated that there was nothing in *Sluder* which supported the Government's position "as applied to the facts of this case" and that "it is not necessary for us to determine whether the [*Sluder*] case was or was not correctly decided on its facts," although the court below was inclined to the view that the Seventh Circuit "did not give full effect to the true nature of a limited overriding royalty or oil payment interest." As indicated above, we can discern no material differences between the cases.

[11] The *Fleming* case below (Appendix B, *infra*, pp. 91-98) also involves another question which is intimately connected with the principal issue. In *Fleming*, the taxpayers received a fee simple interest in real estate in exchange for an oil payment right. Reversing the Tax Court, the Court of Appeals (Judge Borah dissent-

2. For the reasons already stated, the decisions below are erroneous. This Court has held that the capital gains provisions are to be "narrowly applied" so as to effectuate the congressional policy of taxing at ordinary income rates the profits "arising from the everyday operation of a business" while, at the same time, limiting preferential capital gain treatment "to transactions in property which are not the normal source of business income." *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52. And, as the *Corn Products* case demonstrates, a transaction may fit the literal language of the statute and yet not qualify for capital gain treatment where it does not fall within the obvious purpose of Congress and where a taxpayer would otherwise be able (pp. 53-54) "to transmute ordinary income into capital gain at will." Such is the situation here.

In *Burnet* v. *Harmel*, 287 U.S. 103, 106, it was recognized that the production of oil and gas necessarily involved sales of property and that, on the granting of a lease, local law viewed the lessor as transferring title to the underlying minerals. Nonetheless, it was ruled that the production and sale of minerals from a mine or oil well so closely resembled a manufacturing business as to require the conclusion that it was not the purpose of the capital gains provisions to encompass such transactions. Despite the provisions of local law, the decision held that, on the granting of a lease, the lessor did not sell any property and was not entitled to capital gain taxation. And the significant aspect of *Harmel* in

---

ings held that this was a non-taxable exchange of "property" of like kind under Code section 112(b)(4). (Appendix B, *infra*, pp. 94-98). The court went further and stated that, if it was wrong in this conclusion, the gain was taxable as capital gain (Appendix B, *infra*, p. 98).

relation to the issue here is its express holding that a lump sum bonus paid to the lessor by the lessee as consideration for the granting of the lease was taxable as ordinary income, the Court (pp. 111-112) refusing to draw any distinction between the lump sum consideration and the royalties which were to be paid to the lessor over a period of time.

Ever since *Harmel*, it has been clear that lessors and lessees realize ordinary income as the minerals are produced and sold. And the lump sum considerations paid in the present group of cases for the oil payment rights, standing as they do as a substitute for the lessor's or lessee's right to collect ordinary income during a short, future period, no more fit the capital gains provisions of the statute than did the lump sum bonus paid to the lessor in *Harmel*. In *Harmel*, the bonus was consideration for the right to produce and sell minerals for the full life of the lease, and thus was a substitute for the rights which the lessor possessed before granting the lease. See also *Hort* v. *Commissioner*, *supra*. The present group of cases are clearer illustrations of situations where favored capital gain treatment was not within the intendment of Congress, for here the lump sum consideration is a substitute for rights of the transferors which are far more transitory and do not extend through the life of the mineral properties.

The situation here does not even qualify under the literal language of Section 117 which requires that there be a "sale or exchange" of "property." This Court has uniformly held that a temporary, donative assignment of the income from property does not constitute a disposition of the income producing property sufficient for the transferee to be considered the taxable owner of the property or its income. See cases cited *supra*, p. 12. By

transferring no more than the right to collect a definite amount of income (which the transferors would have otherwise collected) out of future production and, in all other respects having retained their interest in the property, the transferors here did not sell any "property", as that term is used in Section 117.[12]

Thomas v. *Perkins*, 301 U.S. 655, and *Palmer* v. *Bender*, 287 U.S. 551, do not support the views of the court below. In *Palmer* v. *Bender*, it was held that an owner of a leasehold interest who transferred it for cash bonus, a future payment of $1,000,000 to be paid out of a fractional part of the oil produced, and a royalty interest, continued to possess a depletable interest in the property. And in *Thomas* v. *Perkins*, where the owner of the leases on *undeveloped* property transferred them for a consideration payable only out of a fractional portion of future production, it was similarly held that the transferor, to that extent, continued to have a depletable economic interest so that the income derived from that interest following the development of the property was attributable to the transferor rather than the transferee. Although those cases are distinguishable in other respects, we need only emphasize at this point that nei-

[12] The Courts of Appeals, in a variety of contexts, have held that a transfer of what is, in effect, a right to collect ordinary income is not a sale of "property" which qualifies for capital gain taxation. See *Helvering* v. *Smith*, 90 F. 2d 590 (C.A. 2d) (right of partner to fees not yet collected); *Rhodes' Estate* v. *Commissioner*, 131 F. 2d 50 (C.A. 6th) (right of stockholder to dividend declared but not yet payable); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6th), certiorari denied, 347 U.S. 1014 (sale of notes with right to collect defaulted interest); *United States* v. *Snow*, 223 F. 2d 103 (C.A. 9th), certiorari denied, 350 U.S. 831, and *Hulbert* v. *Commissioner*, 227 F. 2d 399 (C.A. 7th) (transfer of right to uncollected partnership income). The decisions below conflict, in principle, with these decisions too.

ther case involved the construction or application of the capital gains provision.

3. The decisions below present questions of considerable importance to the administration of the revenue which, we submit, warrant review and definitive adjudication by this Court.

The position of Internal Revenue Service regarding the taxable nature of income realized in transactions of this nature was stated in G.C.M. 24849, 1946-1 Cum. Bull. 66, and was further explained in I.T. 4003, 1950-1 Cum. Bull. 10. A survey conducted by Internal Revenue Service indicates that taxpayers generally accepted the position stated in G.C.M. 24849 and I.T. 4003 (*supra*). However, in the first case to reach an appellate court, the Fifth Circuit rejected the Government's position and held that capital gain was realized by a royalty owner who transferred oil payment rights which paid out in periods ranging from 9 to 13 years. *Caldwell* v. *Campbell*, 218 F. 2d 567.[13] As a consequence of

[13] In its *O'Connor* opinion (Appendix B, *infra*, p. 84), the court stated that the Government conceded, in oral argument that *Caldwell* v. *Campbell*, *supra*, was correctly decided. Such a concession was made only *arguendo* in the court below because of our conviction that, regardless of whether *Caldwell* was correctly decided, the present cases were much closer to *Commissioner* v. *Haden*, 231 F. 2d 340, where a different panel of judges of the Fifth Circuit held that ordinary income was realized where an owner of an oil payment right carved out a smaller oil payment as consideration to the transferee for building a house for the transferor. The court below now seems to explain *Haden* as resting on the ground that the oil payment transfer there was not a sale at all (*O'Connor* opinion, Appendix B, *infra*, pp. 84-87) and thus regards *Caldwell*, rather than *Haden*, as the case which stated generating principles which that court will follow in the future. Because of the Fifth Circuit's explanation of its own decisions, we of course do not concede that *Caldwell* was correctly decided. It should also be noted that, when *Caldwell* was decided, there was then no direct inter-circuit conflict such as now exists (see *supra*, pp. 12-16).

Caldwell and its acceptance by the Tax Court, there is a present tendency for taxpayers to take advantage of those decisions and to formulate transactions accordingly. It has been noted that there has been a recent, "widespread usage" in the oil industry of oil payments "as a device to turn ordinary income into capital gain." 32 Taxes, Tax Magazine, 491, 496 (1954). We are informed by the Internal Revenue Service that, at the present time, this issue is involved in 43 docketed and undocketed cases which, of themselves, represent an estimated loss to the revenue of many millions of dollars if the transferors are held to have realized capital gain rather than ordinary income. And, at least in the Fifth Circuit (where many such cases would probably arise), the decisions below, if not reversed, can be expected to increase substantially the number of transactions and the resulting loss of revenue. In addition, review is justified by the need for resolving the existing conflict between the Fifth and Seventh Circuits (*supra*, pp. 12-16).

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for writs of certiorari should be granted.

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

HERBERT P. ZARKY,
MELVA M. GRANEY,
Attorneys.

APRIL 1957.

interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) [as amended by Sec. 115(b) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Capital Assets.*—The term "capital assets" means property held by the taxpayer whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l) * * * or real property used in the trade or business of the taxpayer.

* * * * * *

(4) [as amended by Sec. 150(a)(1) of the Revenue Act of 1942, *supra*] *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the

the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) *General rule.* If, during the taxable year the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory involuntary conversion * * * of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.112(a)-1 [As amended by T. D. 5402, 1944 Cum. Bull. 229]. *Sales or Exchanges.*—* * *

Exceptions to the general rule are made by section 112(b)(1) to (5), inclusive, * * * in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such

differences are more formal than substantial. As to these, the Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, an the new property are substantially continuations of the old still unliquidated.

* * * * *

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

* * * * *

SEC. 29.112(b)(1)-1. *Property Held for Productive Use in Trade or Business or for Investment.*—As used in section 112(b)(1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact than any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

* * * * *

APPENDIX B

THE TAX COURT OF THE UNITED STATES

P. G. LAKE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[24 T. C. 1076]

Docket No. 48684.

(Filed September 20, 1955)

1. Capital Gain—Oil and Gas—Undivided Interest in Minerals in Place Until Production Equaled a Stated Amount.—The petitioner realized long-term capital gain and not ordinary income when in 1950, in consideration of the cancellation of an indebtedness of $600,000, it transferred 25 per cent of seven-eighths of all oil and gas upon two leases owned by it to its creditor until such time as the payments received by the latter equaled the amount of the debt plus interest thereon.

* * * * * *

Harry C. Weeks, Esq., for the petitioner.
Paul M. Newton, Esq., for the respondent.

OPINION.

MURDOCK, *Judge:* The Commissioner determined deficiencies in income tax of $9,060.79 for 1949, $47,459.09 for 1950, and $12,026.24 for 1951 and a deficiency in excess profits tax for 1950 of $65,044.07. Two

issues are presented for decision. One is whether the petitioner realized a long-term capital gain from the sale in 1950 of a portion of an interest in two oil and gas leases. The facts relating to this issue have been fully stipulated and the stipulation on this and the other issue is adopted, together with all exhibits, as findings of fact in this case.

The petitioner is a Delaware corporation which filed its returns for the taxable years with the collector of internal revenue for the second district of Texas. It was engaged in developing oil and gas properties and producing oil and gas.

The petitioner was indebted to P. G. Lake in the amount of $600,000 on December 29, 1950, and on that date, in consideration of the cancellation of that indebtedness, sold and transferred to him 25 per cent of seven-eighths of all oil and gas upon two leases, entitling him to receive that portion of all production from the leases beginning at 7 a.m., January 1, 1951, until he had received $600,000 net to him, plus an amount equal to 3 per cent per annum payable monthly on the unpaid balance of the $600,000. The petitioner had owned the leases for several years prior to December 29, 1950, and had always held them for productive use in its business and not for sale. The petitioner reported the entire consideration of $600,000 as long-term capital gain on its return for 1950, but the Commissioner, in determining the deficiency, held that the $600,000, less the cost of documentary stamps affixed to the conveyance, was ordinary income subject to the allowance for depletion.

It is held that the petitioner correctly reported its gain from this transaction upon authority of the following cases which the Commissioner concedes are

adverse to his contention: *Lester A. Nordan*, 22 T.C. 1132, in which the appeal of the Commissioner to the Court of Appeals for the Fifth Circuit was dismissed on June 8, 1955; *John David Hawn*, 23 T.C. 516, in which the Commissioner's appeal is now pending in the Court of Appeals for the Fifth Circuit; and *Caldwell v. Campbell*, 218 F. 2d 567. See also *Wm. Fleming*, 24 T.C. ——— (July 29, 1955).

Reviewed by the Court.

Decision will be entered under Rule 50.

UNITED STATES DISTRICT COURT

W. D. Texas, Austin Division.

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of THOMAS O'CONNOR, Deceased, and DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, Joined Herein by Her Husband, D. H. BRAMAN, and THOMAS O'CONNOR, JR., APPELLANTS

v.

FRANK SCOFIELD, Former Collector of Internal Revenue, APPELLEE

[143 F. Supp. 240]

Civil Action 824. March 28, 1956.

RICE, *District Judge*.

This case arises under the provisions of the Internal Revenue Code of 1939, 26 U.S.C.A. § 1 et seq. It involves income taxes together with interest paid by the Estate of Thomas O'Connor, Deceased, for the taxable year ended November 30, 1948.

The above entitled action was tried without jury by the Court in San Antonio, Texas, on November 4, 1955.

The question involved in the case is as follows:

Were the plaintiffs taxable at long term capital gain rates or at ordinary income rates on the gain realized from the sale of an oil payment during the fiscal year ended November 30, 1948, to D. E. Blackburn?

The Court having considered the oral testimony, stipulated facts and the briefs of counsel and being fully advised otherwise in the premises, makes and enters the following findings of fact and conclusions of law.

Findings of Fact

1. Thomas O'Connor died testate in Victoria County, Texas, on December 5, 1946. Plaintiffs Dennis M. O'Connor and Katherine O'Connor, duly qualified as Independent Executors of the Estate of Thomas O'Connor, Deceased, and are now acting in such capacity. Plaintiffs Dennis M. O'Connor, Katherine O'Connor, Mary O'Connor Braman and Thomas O'Connor, Jr. are the sole heirs at law and devisees under the will of Thomas O'Connor, deceased. D. H. Braman is the husband of Mary O'Connor Braman.

2. In the fiscal year of the Estate ended November 30, 1948, to wit, on November 26, 1948, the Executors of the Estate transferred, by general warranty deed, certain royalty interests (subject to a reversionary interest, as hereinafter stated) to D. E. Blackburn of Victoria, Texas, for the cash consideration of $9,990,350. The deed making such transfer was delivered to D. E. Blackburn and duly recorded in the Deed Records of Refugio County, Texas, with some $10,000 in documentary stamps having been attached to the deed. Expenses attributable to the sale

amounted to $10,990. The royalty interests sold to Blackburn had been held by decedent and subsequently by his Estate for many years. The properties sold to Blackburn had been held by plaintiffs in excess of six months.

3. If the gain from the transaction in question is properly taxable as income on the sale of a capital asset held for more than six months, and not as ordinary income, the basis for computing such gain is $1,325,105.81.

4. The above mentioned transaction was consummated on November 26, 1948 and was carried out in accordance with its terms. Blackburn, as owner of the royalty interest, received the money from the companies running the oil from the properties, pursuant to transfer orders executed by plaintiffs to the respective pipe line companies.

5. The deed above referred to provided that after the royalties described therein had produced sufficient oil to pay the purchaser, D. E. Blackburn, the sum of $10,000,000.00 (with interest as computed thereon at the rate of 4% per annum), the properties would revert to the grantors. The aforesaid amount was duly received by Blackburn from said properties during the period beginning January 28, 1949 and ending December 24, 1951. Upon receipt of this amount, Blackburn, the purchaser, pursuant to the provisions in the deed, executed his quitclaim deed, reconveying the royalties to the Estate, which quitclaim was duly recorded in the Deed Records of Refugio County, Texas.

6. Both the sellers and the buyer (D. E. Blackburn) intended the transaction in question to be a sale and purchase of the royalty interests in question. They did not intend to enter into a loan or a mortgage transaction. At no time did the Executors, individually, or in

their fiduciary capacity, make any guaranty or agreement to indemnify the purchaser or enter into agreements with the purchaser other than the agreement to sell, as set forth in the deed. At all times, the risks incident to the presence and production of sufficient quantities of oil to make the transaction profitable for the purchaser were upon the purchaser. The purchaser, D. E. Blackburn, borrowed the purchase money from Chase National Bank of New York, giving his note and a deed of trust on the properties purchased by him. The bank dealt only with Blackburn and looked only to him. The plaintiffs did not have anything to do with Blackburn's bank loan. The transaction in question was real and bona fide and was, in no sense, a sham or a subterfuge. Blackburn made a substantial profit on the transaction and reported and paid tax on his profit.

7. The purpose of the sale of the oil payment was a bona fide business purpose, to wit, to raise money to pay federal estate taxes and state inheritance taxes due by reason of the death of Thomas O'Connor, deceased, and to pay administration expenses of the Estate. The Estate was in need of cash resources with which to pay these charges and for these reasons the oil payment was sold.

8. The sale in question was the first and only sale of oil payments or other mineral interests that the Estate had made until that time. Neither the decedent, Thomas O'Connor, nor his Estate, was in the business of selling oil payments or other mineral interests. The limited royalty interests, the oil payment in question, was not held primarily for sale to customers.

9. The oil payment "paid out" after three years of production, during which the properties were owned by Blackburn. The oil payment would have taken an

appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale of the oil payment, which higher price was maintained during the period of the pay out.

10. The royalty interest (or oil payments) sold to Blackburn represented a substantial part of the plaintiffs' oil in place. Also, in terms of the relative values of the interest sold and of the reversionary interest retained by the sellers, the transfer represented a substantial part of the sellers' royalty interest.

11. The Executors of the Estate of Thomas O'Connor, Deceased, filed a fiduciary income tax return for the fiscal period ended November 30, 1948, reporting the gain on the sale as ordinary income. This gain was reported as ordinary income because of the ruling of the Commissioner of Internal Revenue, published in 1948, requiring such gain to be so reported. Thereafter, a timely claim for refund was filed, which was rejected (except as to a minor item not here involved), notification of such rejection being received in a registered letter dated March 12, 1953, and subsequently, this suit was brought within the time prescribed by the Internal Revenue Code.

12. There was probable and reasonable cause for the acts done by Frank Scofield, the former Collector of Internal Revenue, acting pursuant to the orders and directions of the Commissioner of Internal Revenue.

Conclusions of Law

1. This Court has jurisdiction of the subject-matter of and the parties to this case.

2. The transaction with D. E. Blackburn was a bona fide sale.

3. The sale to Blackburn was a sale of a royalty interest in producing oil properties in Texas, subject to a reversion to plaintiffs after the royalties had produced in Blackburn's hands the prescribed amount. This was a sale of what is commonly called an oil payment. This oil payment was a real property interest under the law of Texas and, under the tax laws, a property interest in oil in place. The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. The property so sold was a long-lived, and not a short-lived, oil payment.

4. The property interest so sold to Blackburn was a capital asset as defined in Section 117 of the Internal Revenue Code of 1939, and this capital asset had been held by plaintiffs for more than six months.

5. None of the exceptions in Section 117 or elsewhere in the Internal Revenue Code, denying a transaction long-term capital gain treatment, are applicable to the instant transaction.

6. Plaintiffs are entitled to receive long term capital gain treatment under Section 117 on the sale of the oil payment in question to Blackburn.

7. Judgment shall be entered for the plaintiffs. By reason of the probable cause for the acts of the Commissioner or other officials of the Treasury Department, as found by the Court, the judgment, on becoming final, shall be provided for and paid out of the proper appropriations from the Treasury of the United States.

THE TAX COURT OF THE UNITED STATES

WM. FLEMING and BESSIE M. FLEMING, HUSBAND AND WIFE, ET AL.,[1] PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[24 T. C. 818]

Docket Nos. 46713, 46781, 46782.

Filed July 29, 1955.

1 and 2. *Exchanges Solely in Kind—Capital Gain—Sec. 117 (j), I. R. C., of 1939.*—Petitioners exchanged oil payments for land. *Held*, that the property was of unlike kind within the meaning of section 112(b)(1), and the gain was taxable as capital gain.

Henry C. Weeks, Esq., for the petitioners.
Daniel A. Taylor, Esq., for the respondent.

OPINION

JOHNSON, *Judge:* Respondent determined deficiencies in income tax as follows:

Docket No.	Petitioner	Year	Deficiency
46713	Wm. Fleming and Bessie M. Fleming	1948	$94,113.30
46781	E. Howard Walsh and Mary D. Walsh	1948	2,301.31
		1949	38,550.52
46782	Mary D. Fleming Walsh	Fiscal year ended 8-31-48	51,976.17
		Fiscal year ended 8-31-49	31,278.55

The issues presented are:

(1) Whether an exchange of limited overriding royalties or oil payment interests for the fee simple

[1] The following proceedings are consolidated herewith: E. Howard Walsh and Mary D. Walsh (husband and wife), Docket No. 46781; Mary D. Fleming Walsh, Docket No. 46782.

title to a ranch was an exchange solely in kind under section 112(b)(1), Internal Revenue Code of 1939. In the alternative, if a gain is recognized, is it a capital gain, or ordinary income with depletion allowable?

(2) Would the tax consequences resulting from the exchange above be different where urban real property is substituted for the ranch?

* * * * * *

Petitioner Mary D. Fleming Walsh has stipulated that she is liable as a transferee for whatever deficiencies in income tax are finally determined against Wm. Fleming, Trustee, for the fiscal years ended August 31, 1948, and August 31, 1949.

All of the facts have been stipulated and are so found and we summarize therefrom as follows:

Wm. Fleming and Bessie M. Fleming were husband and wife, as were F. Howard Walsh and Mary D. Walsh. Mary D. Fleming Walsh (Mary D. Walsh) was also the daughter of Wm. Fleming. All petitioners were residents of Fort Worth, Texas, and their income tax returns were filed on a cash basis with the collector of internal revenue for the second district of Texas.

Issue 1.

For all the years before us Wm. Fleming was the sole trustee and Mary D. Walsh was the sole beneficiary of the private trust known as Wm. Fleming, Trustee. This trust was created in 1931 and continued in existence until 1950. The trust kept its books on a cash basis for a fiscal period ending August 31 of each year, and its income tax returns were filed with the collector of internal revenue for the second district of Texas.

For the years before us the Fleming Oil Company

was a partnership composed of Wm. Fleming and Wm. Fleming, Trustee. The partnership produced oil and gas, and made investments. Wm. Fleming held a 61.026 per cent interest in the business, and Wm. Fleming, Trustee, a 38.974 per cent interest. Partnership books were kept on a cash basis, and tax returns for the partnership were filed with the collector of internal revenue for the second district of Texas.

On May 19, 1948, Marie Hildreth Cline (joined by her husband) conveyed an undivided fee simple title to 2,994.5 acres of ranch land to the Fleming Oil Company (.50 per cent), Wm. Fleming, Trustee (.25 per cent), and Wm. Fleming (.25 per cent). As consideration for this conveyance the grantees of the land conveyed and assigned to Marie Hildreth Cline certain limited overriding royalties or oil payment interests. These limited overriding royalties or oil payment interests came from oil and gas leases, or oil and gas mineral leases, which the transferors had owned for more than 6 months prior to May 19, 1948, for productive use in their respective trades and businesses and not for sale. The ranch was acquired for investment and not for sale.

Pertinent parts of the various oil payments to Marie Hildreth Cline are presented below:

In the first, the Fleming Oil Company, as owner of one-half of seven-eighths of certain oil and gas leasehold estates does hereby sell, assign, and convey unto the said MRS. MARIE HILDRETH CLINE, as a part of her separate property and estate, her heirs and assigns, the following described real property, to-wit:

> An overriding royalty and mineral interest carved hereby out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases

described above, amounting to an undivided 49 128ths interest in and to all the oil in, under, and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of One Hundred Forty-seven Thousand Dollars ($147,000.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $147,000.00 which may be unsatisfied from time to time.

This grant was made subject to certain conditions, limitations, and agreements, such as:

(4) No interest in the gas or casinghead gas in, under, or produced and saved from said tracts, and no interest in the personal property now or hereafter placed thereon is assigned or conveyed to grantee, this conveyance affecting the oil only.

(5) When and if the grantee herein, her heirs and assigns have received from the fractional interest hereby assigned, ~~oil or~~ the net value of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, then the interest hereby conveyed to said grantee shall cease and terminate, and said interest shall revert to, and shall thereafter be owned by grantor, its successors, heirs or assigns; and grantee, her heirs and assigns, shall have no further interest in said oil and gas leasehold estates covering said land, or in the oil thereunder; and grantee, her heirs or assigns, shall,

upon request, execute such instruments as may be necessary or proper to evidence this of record.

(6) The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom that grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require grantor to develop and operate said property in accordance with the terms of the original leases upon said property as the original lessors therein, their heirs or assigns, might have or exercise.

Marie Hildreth Cline's share of oil produced from the property described in the Fleming Oil Company assignment, from the effective date of the assignment to the close of 1952, amounted to:

Year	*Amount*
1948	$15,801.16
1949	22,835.94
1950	31,172.41
1951	31,350.19
1952	30,559.54

In the next oil payment, Wm. Fleming, as owner of an undivided interest in certain oil and gas leases does hereby sell, assign, and convey unto the said MRS. MARIE HILDRETH CLINE, as a part of her separate prop-

erty and estate, and to her heirs and assigns, the following described real property, to wit:

> An overriding royalty and mineral interest carved hereby out of the interest owned by Wm. Fleming in each and all of the oil and gas leases described above, amounting to a .166668 interest in and to all the oil in, under, and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of Seventy-three Thousand Five Hundred Dollars ($73,500.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $73,500.00 which may be unsatisfied from time to time.

This grant was also made subject to certain conditions, limitations, and agreements. These were similar to those in the Fleming Oil Company assignment. Marie Hildreth Cline's share of oil produced from this property, from the effective date of the assignment to the close of 1952, amounted to:

Year	*Amount*
1948	$5,423.49
1949	9,412.84
1950	7,916.69
1951	4,854.74
1952	6,420.78

The oil payment from Wm. Fleming, Trustee, conveyed to Marie Hildreth Cline the following described interest:

An overriding royalty and mineral interest carved hereby out of the interest owned by Wm. Fleming, Trustee, in each and all of the oil and gas leases described above, amounting to an undivided 6.100ths interest in and to 7 8ths of all the oil in, under, and that may be produced, saved and marketed from the above described tract of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of Forty-nine Thousand Dollars ($49,000.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $49,000.00 which may be unsatisfied from time to time.

Like the other grants, this was also subject to certain conditions, limitations, and agreements. Marie Hildreth Cline's share of the oil produced from this property, from the effective date of the assignment to the close of 1952, amounted to:

Year	*Amount*
1948	$1,436.99
1949	7,365.73
1950	7,423.68
1951	7,793.11
1952	7,730.24

Wm. Fleming, Trustee, also conveyed by a mineral deed certain royalty interests to Marie Hildreth Cline as part consideration for the ranch. In this deed the trust did "grant, sell, and convey unto the said grantee, as a part of her separate property and estate, an undivided .32,3535 100ths royalty interest in and to

all of the oil in, under, and that may be produced from certain real property. The deed further provided:

> Said land being now under an oil and gas lease, it is understood and agreed that this sale is made subject to the terms of said lease, but covers and includes 32.3535 100ths of the 1/8th royalty on oil due and to be paid under the terms of said lease, insofar as it covers the above described land, until the grantee named above shall have received oil of the net value of Twenty-four Thousand Five Hundred Dollars ($24,500.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $24,500.00 which may be unsatisfied from time to time.

Like the other grants, this was also made subject to certain conditions, limitations, and agreement. Marie Hildreth Cline's share of the oil produced from this property, from the effective date of the conveyance to the close of 1952, amounted to:

Year	*Amount*
1948	$2,306.57
1949	3,393.20
1950	3,913.38
1951	3,985.71
1952	3,248.27

On the tax returns of Wm. and Bessie M. Fleming and the Fleming Oil Company (a partnership), for the calendar year 1948, and Wm. Fleming, Trustee, for the fiscal year ended August 31, 1948, the exchange of the ranch for the oil payments was treated as an exchange of property of like kind under section 112(b)(1). However, respondent determined that they received a

gain from this exchange and adjusted their 1948 income accordingly. Respondent explained this adjustment to Wm. and Bessie M. Fleming's 1948 net income as follows:

> (d) Your gain on the exchange of an oil payment, face amount $73,500.00, plus 5% interest payable out of 40% of 41.067 W. I. in State (Choate) Lease, Eddy County, New Mexico, for a 1/4 undivided interest in 2,994 1/2 acres in Parker and Tarrant Counties, Texas, has been computed as follows:
>
> | | |
> |---|---|
> | Consideration, fair market value of land received, held to be face value of oil payments | |
> | 1/4 of $294,000 | $73,500.00 |
> | Cost basis of oil payment assigned, depletion, 27 1/2%, of $73,500 | 20,212.50 |
> | Income increased | $53,287.50 |

Respondent's determination, tabulated for each of the assignors, is as follows:

	Fleming Oil Co.	Wm. Fleming	Wm. Fleming, Trustee
Fair market value of interest at Choate ranch received	$147,000.00	$73,500.00	$73,500.00
Net cost or basis of property transferred	1,102.70		18,119.21
Percentage depletion allowable to	40,425.00	20,212.50	20,212.50
Net income from exchange received	106,575.00	53,287.50	53,287.50

Since the Fleming Oil Company was a partnership, in the final adjustment respondent distributed the partnership income to the partners; the beneficiary's income from the trust was also adjusted.

The exchanges by Fleming Oil Company, Wm. Fleming, and Wm. Fleming, Trustee, of oil payments out of oil and gas leases situated in the counties of

willingness to purchase a portion of that royalty interest and negotiations followed.

Petitioner and Munro discussed the amount of money petitioner would probably need in later years to pay his taxes, the probable amount of sulphur still in place (which they estimated to be about 35 million tons), the anticipated annual rate of sulphur production, the annual royalty payments which would probably be received by a purchaser of petitioner's interest, the probable amount of time required for pay outs from sulphur production of different sums of money, the discount factor (such as the interest Munro would have to pay on funds borrowed by him to purchase the royalty interest which affected Munro's profit from the transaction, and the tax savings to petitioner.

It was finally agreed that the transaction would be based upon petitioner's anticipated requirements for funds to pay taxes for the succeeding 3 years, and upon a 4-year pay out period from sulphur production to Munro. On this basis, it was determined that petitioner would assign to Munro a portion of his royalty interest on 6,000,000 long tons of sulphur, from which Munro would receive $50,000 within about 4 years, and that, in return, Munro would pay petitioner $46,500 over a 3-year period. Munro advised petitioner that the latter's tax savings resulting from the transaction would be about $1,000 to $4,500 and Munro estimated that his own profit from the transaction (after allowance for the discount factor) would approach $2,000.

On December 24, 1947, petitioner executed a deed conveying to Munro 86.254514 per cent of his pooled royalty interest of $0.009661[illegible] (i.e., $0.00833333) per long ton on 6,000,000 long tons of sulphur to be produced from

Howard, Gregg, and Cooke in the State of Texas and Eddy County, New Mexico, for fee simple title to 2,394½ acres of ranch lands situated in Parker and Tarrant Counties, Texas, were not exchanges of property for property of a like kind and the gains derived therefrom was capital gain.

In this first issue the question is whether the exchange here of limited overriding royalties or oil payment interests for the fee simple title to ranch land was an exchange of "property of a like kind" within the meaning of section 112(b)(1), Internal Revenue Code of 1939.[1] If so, petitioners' gain therefrom should not have been recognized in computing their taxable income, since the parties admit the existence of the other requirements of the section. Petitioners contend the properties were of like kind, while respondent determined that they were not.

Treasury Regulations, in defining the meaning of "like kind" as here used, state that same "have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class." The meaning of the words in there further particularized by citing examples of nontaxable exchanges, which include exchange of "city real estate for a farm or ranch, or a leasehold of a fee with 30 years or more to run for real

[1] SEC. 112. RECOGNITION OF GAIN OR LOSS.

(b) *Exchanges Solely in Kind*

(1) *Property held for productive use or investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment * * * is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment

Boling Dome. In consideration therefor Munro gave petitioner:

Check dated Dec. 24, 1947	$13,000
Promissory note due Dec. 24, 1948, with 6 per cent annual interest after maturity)	16,500
Promissory note due Dec. 24, 1949 (with 6 per cent annual interest after maturity)	16,500
	$46,500

Pertinent portions of the assignment follows:

I, W. F. Weed, in consideration of [$13,000 cash and the two $16,500 notes] * * *, do hereby SELL, TRANSFER and ASSIGN, unto the said Marion F. Munro, * * * 86.25451% of $.00960133 per long ton pooled royalty on sulphur produced by Texas Gulf Sulphur Company at Boling Dome, Wharton County, Texas, from lands and premises described in said above named conveyances [to petitioner from his father and his father's estate], until six million (6,000,000) long tons of sulphur have been produced and accounted for to the said Marion F. Munro therefrom, which royalty so sold and here assigned and conveyed amounts to $.00833333 per long ton.

* * * * * *

This assignment and the royalty transferred and assigned hereby on sulphur produced from Boling Dome, * * * shall continue to be effective until said Marion F. Munro shall have received said royalty on six million (6,000,000) long tons of sulphur and no longer. * * *

The following statement shows the payments made by Munro to petitioner, pursuant to the above conveyances, and the method of financing used by Munro:

estate, or improved real estate for unimproved real estate". See Regs. 111, sec. 29.112(b)(1)-1.

Similar interpretations have appeared in all of the regulations, beginning with Regulations 62, issued under the Revenue Act of 1921. These have all likewise interpreted the term "like kind," and the statute in question has been repeatedly re-enacted by Congress without change since the Revenue Act of 1924. "Under the established rule Congress must be taken to have approved the administrative construction and thereby to have given it the force of law." *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110. This regulation has also been uniformly followed and approved by the courts.

Applying the above regulations to the facts here, we do not think the properties in question have the same "nature or character," nor are they of the same "kind or class," hence they are not "of a like kind" within the meaning of the statute.

In comparing properties to determine their likeness within the meaning of section 112(b)(1), we must consider not alone the nature and character of the physical properties, but also the nature and character of the title conveyed or the rights of the parties therein. The accepted legal definition of "property" so contemplates and requires. We quote:

> In law it is not the physical, material object alone which constitutes "property." The term means something more than the mere thing which a person owns. * * *
>
> [73 C.J.S. 138]

The word "property" means not only the thing possessed, that is the physical, corporeal thing, but

also *rights* in the physical, corporeal thing which are created and sanctioned by law. [73 C.J.S. 140; *Texas Co. v. Hamptman*, 91 F. 2d 149 and other cases there cited.]

The rights created in the property determine the character of the property owned.

The above-cited regulation gives recognition to this legal definition of property. In effect it provides that even if both properties exchanged are realty, if there be substantial difference in the rights created in and to the respective properties, then the properties are not of a like kind. Illustrative of this, it provides that a leasehold interest in land cannot be exchanged for a fee title in land without tax consequences, unless the lease has "thirty years or more to run." The implication is clear that the rights created in the respective grantees in and to the properties exchanged must be of the same general character or of substantial equality. If not, then the properties exchanged are not of like kind within the meaning of the Code. It was so held in *Midfield Oil Co.*, 39 B.T.A. 1151, relied upon by respondent, and which sustains his contention here. There it was held that an oil payment limited in amount is different within the meaning of section 112(b)(1) from an overriding royalty which continues as long as production lasts.

The reason there given for holding the properties unlike was because of the real differences in the rights created by the Holman oil payment and the Dawson

[1] This provision of the regulation was discussed and approved in *Century Electric Co.*, 15 T.C. 581, affd. 192 F. 2d 155, certiorari denied 342 U.S. 954. In *Stocks Block Co. v. Maryland Co.*, 15 T.C. 41, it was held a lease for 21 years was not equivalent to a fee

overriding royalty," which were held to be "differences of substance and not of mere form." The rights under the Holmans oil payments were to continue only until a specified sum of money was realized therefrom, while the Dawson royalty rights "continued for so long as oil or gas might be produced from the property."

In the instant case the rights created in the overriding royalties or oil payments were almost identical with those created in the Holmans oil payments, the only difference being the amount in dollars and cents to be paid, but in both, upon completion of payment of the sum specified, the oil interests assigned were to revert to the grantor. *Midfield Oil Co., supra*, was approved and followed by Kay Kimball, 11 B.T.A. 940.

Petitioners cite *Commissioner v. Crichton*, 122 F. 2d 181, affirming *Kate A. Crichton*, 42 B.T.A. 490, where it was held that an exchange of an undivided interest in oil, gas, and other minerals for an undivided fee in a parcel of improved realty was an exchange within the meaning of section 112(b)(1).

That case does not sustain petitioners' contention here. There the mineral interest conveyed was not for a limited period but was an outright and absolute conveyance of the "oil, gas and other minerals in, on and under and that may be produced from" the land therein described. There was no limitation or restriction of any kind. The difference in this respect from *Midfield Oil Co., supra*, is pointed out in the Board of Tax Appeals' opinion in the *Crichton* case, *supra*. (See 42 B.T.A. at p. 492.)

Petitioners rely on *Flemming v. Campbell*, (C.A. 5) 205 F. 2d 549, reversing a United States District Court for the Northern District of Texas case (Sept. 29, 1952). The appellate court in its reversal held that an

exchange of a limited overriding royalty or oil payment solely for a determinable fee in an oil and gas lease was an exchange of property of like kind within the meaning of section 112(b)(1)." Apparently Government Counsel therefore rested their case solely on the ground

> that the mineral interest in the Ector County lands was an interest in fee and that in the Gregg County lands, for which it was exchanged, was a leasehold of a type which does not have thirty or more years to run, and hence that therefore under the regulation the interests exchanged were not of like kind.

The court decided the case on the issue as presented and held that both interests exchanged were interests in minerals in place and hence both were interests in land; further, that neither interest was a "leasehold of a fee" in the sense that term is used in the regulation, and therefore the 30-year provision of the regulation did not apply. The issue there is not present in the instant case and the facts here are wholly different.

Here the exchange was not "mineral interests for mineral interests," but an exchange of a fee simple title, an absolute estate in such land for a limited mineral interest which expired when a definite sum of money was realized therefrom.

Notwithstanding the comprehensive terms of conveyance contained in the assignment of the mineral interest, the ceiling limitation therein, whereby the maximum amount the grantee could ever receive therefrom was a fixed sum of money with interest, strips the extent of grantee's rights therein more in the nature of a mortgagee than that of owner. The grantee's interest

was primarily monetary and of a temporary nature. The grantors at all times owned a residuary title in the mineral property. In any event a temporary title to the oil properties, continuing only until a sum of money is realized therefrom, is not equivalent to an absolute and unconditional title in the ranch land. The rights created were wholly different. The properties here exchanged were not of like kind within the meaning of section 112(b)(1).

Now that we have determined that there was a taxable gain from the exchange, we must ascertain whether it was ordinary income, as determined by respondent, or capital gain, as contended by petitioners. This question must be decided in favor of the petitioners upon authority of *John Wood Hawn*, 23 T.C. 510, *Lester A. Nordan*, 22 T.C. 1132, and *Caldwell v. Campbell, Jr.*, 218 F. 2d 567, from which this case is not distinguishable in principle. See *Walter A. Henshaw*, 23 T.C. 176. These cases hold that an oil payment is a capital asset and the gain derived from the sale or exchange of an oil payment may be given capital gains treatment. Similarly, the petitioners' gain from the exchange of the oil payments is entitled to capital gains treatment. Petitioners are sustained on this question.

In arriving at our conclusion that petitioners' gain was a capital gain, we have considered, but cannot sustain, respondent's contention that petitioners' transaction was the mere assignment of future income in exchange for a ranch.

Issue II.

On October 5, 1949, C. C. Cross conveyed to E. Howard Walsh the fee simple title to certain urban real estate

in Fort Worth Texas. As the sole consideration for this land, F. Howard Walsh conveyed to Cross certain limited overriding royalties or oil payment interests. Walsh's conveyance to Cross was in part as follows:

> F. Howard Walsh, does hereby, subject to the conditions and limitations hereinafter set out, bargain, sell, assign and convey unto C. C. Cross, of Tarrant County, Texas, his heirs and assigns, the following described overriding royalty and mineral interests carved out of the interests owned by the undersigned grantor in and to the oil and gas leases and leasehold estates, insofar as they cover the tracts of land and leases described above, such interests herein conveyed being the following fractional parts of the oil, in, under, or upon, or that may be produced from such tracts of land under the terms of said leases, to wit:
>
> (a) $\frac{1}{4}$ of $\frac{7}{8}$ of such oil, insofar as all of the tracts and leases in Ward County above described are concerned, save and except Walsh's "Killough" Lease; and
>
> (b) $\frac{1}{4}$ of 7/16 of such oil, insofar as such Killough Lease is concerned.
>
> This grant is made subject to the following conditions and limitations, to-wit:
>
> * * * * * *
>
> (c) When and if Cross, or his heirs and assigns, shall have received, under the terms of said conveyance and assignment, oil of the net value of SIXTY-FIVE THOUSAND AND NO/100 DOLLARS ($65,000.00), plus interest at the rate of seven (7) per cent per annum on the balances unpaid from time to time

(exclusive of gross production taxes, which may be deducted from Cross's part of the oil), then Cross shall have no further interest in said oil and gas leases or leasehold estate, and the oil then remaining in, under or upon said tracts of land, or thereafter produced therefrom; and the interests hereby conveyed shall automatically revert to WALSH, his heirs and assigns.

Cross's share of the oil produced from the property named in the conveyance, from the effective date of the conveyance to the close of 1952, amounted to:

Year	*Amount*
1949	$ 3,909.61
1950	22,301.12
1951	22,073.03
1952	21,793.90

On their 1949 income tax return E. Howard Walsh and his wife treated this transaction as an exchange of property of like kind under section 112(b)(1). Respondent determined that the transaction produced ordinary depletable income for them. Respondent also determined that the real estate acquired by Walsh had a market value of $65,000, that the limited overriding royalties or oil payment interest had no basis in Walsh's hands, and that the allowance for depletion was $17,875, with a net income of $17,125 taxable to Walsh and his wife in 1949.

The exchange by E. Howard Walsh of an oil payment out of oil and gas leases situated in Ward County, Texas, for fee simple title to revenue-producing real estate situated in Fort Worth, Tarrant County, Texas, was not an exchange of property for property of a like

kind and the gain derived therefrom is taxable income.

In this issue petitioners F. Howard Walsh and Mary D. Walsh conveyed an oil payment to C. C. Cross for a piece of urban real property. There is no real difference between this exchange and that we discussed in the first issue. Therefore, for the reasons stated in the first issue, petitioners' gain in this issue is taxed like the gain considered in the first issue.

* * * * * * *

Decisions will be entered under Rule 50.

THE TAX COURT OF THE UNITED STATES

JOHN WRATHER and NELL WRATHER, Husband and Wife, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

T. C. Memo. 1955-101

Docket No. 38267

Filed April 26, 1955

Allen E. Pyle, Esq., for the petitioners.

John P. Higgins, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JOHNSON, *Judge*: Respondent determined deficiencies in petitioners' income tax for 1948 and 1949 in the amounts of $112,715.34 and $72,404.66, respectively.

our recent decisions in *Lester A. Nordan*, 22 T.C. 1132; *John David Hamm*, 23 T.C. 516, now on review in the Fifth Circuit; and other cases which were cited and discussed in the *Nordan* and *Hamm* cases. We think petitioner must prevail on the strength of these authorities, as well as the more recently decided *Caldwell v. Campbell*, (C.A.5) 218 F. 2d 567; *Wm. Fleming*, 24 T.C. (July 29, 1955); and *A. J. Slaughter, Jr.*, 24 T.C. (Aug. 25, 1955). It is true that in the aforementioned cases the mineral interests which were involved were oil payments, whereas here sulphur payments are involved. However, we think that fact makes no difference and that the same rule must be applicable to the sale and transfer of sulphur payments as applies to the sale and transfer of oil payments.[2] We so hold and, following the above decisions, we decide this issue in favor of petitioner. Since those cases adequately discussed the point of law involved it is unnecessary to here repeat the discussion.

In his brief, respondent attempts to distinguish the *Nordan*, *Hamm*, and *Caldwell* cases, all *supra*, upon the grounds that the taxpayers therein transferred their *entire* interests in oil in place, retaining only a reversionary interest therein after satisfaction of the oil payments from the interests conveyed, whereas here petiti-

[2] Cases dealing with minerals other than oil and gas have played their parts in the development of the law applicable to oil and gas. See, e.g., 63 I.D. 22730, 1941-1 C.B. 214, citing *Bankers' Pocahontas Coal Co. v. Burnet*, 287 U.S. 308 (coal). Conversely, we think that those principles stated in oil and gas cases are applicable alike to other minerals, absent evidence of special circumstances compelling a distinction (such as substantial differences in controlling provisions of the Internal Revenue Code). As stated in 63 I.D. 22730, *supra*, at page 219, "Like issues arise in the oil and mineral cases which are cited interchangeably in the evolution of the applicable rules."

The following issues are presented in this proceeding:

(1) Was petitioners' gain from the sale of an oil payment in 1948 ordinary income or capital gain?

Findings of Fact

Some of the facts are stipulated and are incorporated herein by this reference.

John and Nell Wrather, husband and wife, were residents of Longview, Texas. They filed joint tax returns for 1948 and 1949 with the collector of internal revenue for the second district of Texas. John Wrather will hereinafter be referred to as the petitioner.

Issue 1.

Facts. During 1948 and 1949 petitioner, T. W. George, and F. B. Wimberly were partners in a business known as George & Wrather Drilling Company, hereinafter referred to as the partnership.

In 1948 petitioner, George and Wimberly, as partners, held certain oil and gas lease assignments for tracts of land known as the Brown Lease and the Knotts "A" Lease. Both leases were productive and had produced income for the partnership prior to 1948. By a contract dated June 19, 1948, the partners and their wives, as individuals and for the partnerships sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., hereinafter referred to as the Cooperative, an oil payment in the amount of $130,000 to be paid out of $\frac{7}{8}$ 10ths of $\frac{7}{8}$ 24ths of $\frac{7}{8}$ 8ths of the oil produced and saved from the Brown Lease. In consideration for this oil payment assignment the Cooperative paid the partnership $125,000 in cash on or about the date of the assignment.

By another conveyance dated June 19, 1948, the partners and their wives, as individuals and for the partnership, sold and conveyed to the Cooperative an oil payment in the amount of $155,000, to be paid out of 9/10ths of 5/16ths of 7/8ths of all the oil produced and saved from the Kieffer "A" Lease.

On August 16, 1948, the partners and their wives conveyed to the Cooperative another $12,500 oil payment out of the Kieffer "A" Lease. In consideration for these oil payments from the Kieffer "A" Lease, the Cooperative paid the partnership $102,500 cash on or about the date of the assignments.

In June 1948 the Cooperative received its first proceeds attributable to the oil payments from both leases. By January 1952, the Cooperative had received $130,000 from the Brown Lease and by June 1953, $167,500 from the Kieffer "A" Lease. The reasonable pay out time on the three interests was calculated at the time of the assignment to be from four to six years.

Opinion. In this first issue the questions of fact have been stipulated and the remaining question of law is whether petitioner's share of the gain from the sale of an oil payment is a capital gain or ordinary income. Petitioner reported the gain as capital gain but respondent determined it to be ordinary income.

The decision in this case is controlled by the decisions in prior cases involving the sale and exchange of oil payments.

In *Orlic Oil Co.*, 57 B.T.A. 656, affd. 162 F. 2d 508, it was held that the grantor of an oil payment realized a taxable gain on the sale of an oil payment. The gain was based on the consideration received for the oil payment, but the court did not discuss the question of whether the gain was capital gain or ordinary income.

In a later case *John David Hawn*, 23 T.C. 516, the Court was required to decide whether the consideration received by Hawn in exchange for an oil payment constituted capital gain or ordinary income. The Court, following *Lester A. Nordan*, 22 T.C. 1132, held that Hawn's conveyance of an oil payment was a transfer of a capital asset, and the gain realized therefrom was taxable as capital gain.

Similarly, it was held by the Court of Appeals, Fifth Circuit, in *Caldwell v. Campbell*, 218 F. 2d 567, where a taxpayer transferred oil payments in exchange for cash and notes, that the oil payments were capital assets. The gain was then held to be taxable as capital gain.

Since the *Hawn*, *Nordan* and *Caldwell* cases have established that oil payments should be treated as capital assets, and since we are unable to distinguish the oil payments in the present case from those in the *Hawn*, *Nordan* and *Caldwell* cases, we must find that the oil payments conveyed by petitioner to the Cooperative were capital assets. Further, since there is no dispute that the properties were held for more than six months, petitioner's gain is taxable as capital gain under section 117 of the 1939 Code.

Decision will be entered under Rule 50.

Slaght et. Ux., all *supra*, reveals that in fact the taxpayers therein did *not* convey their entire interests but, as did petitioner here, carved out the transferred mineral payments from the entire interests which they owned.

Respondent in his determination of the deficiencies has allowed petitioner percentage depletion on the money received from Munro for sale of the sulphur payment. But petitioner was not the owner of the sulphur royalties at the times he received such money from Munro and, therefore, was clearly not entitled (nor does he claim to be so entitled) to any deductions for depletion. See *John David Hawn, supra*.

Having decided the primary issue in petitioner's favor it is not necessary to decide his alternative contention that, if we should hold that his gains from the sale and transfer to Munro are taxable as ordinary income, then it should all have been reported in 1947, the year of sale, and that none should have been reported in 1948 and 1949.

Decision will be entered under Rule 50.

THE TAX COURT OF THE UNITED STATES

W. F. WEED, INDIVIDUAL, AND ESTATE OF LEONARD W. WEED, DECEASED, W. F. WEED, EXECUTOR, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[24 T.C. 1025]

Docket No. 46312

Filed September 22, 1955.

Held, the gain resulting from W. F. Weed's sale and transfer of a sulphur payment carved out of his pooled royalty interests in sulphur produced from deposits in place, which interests Weed had owned for several years prior to the date of sale, was taxable as long term capital gain on the installment basis and not as ordinary income.

Peter B. Wells, Esq., for the petitioners.

W. B. Rehm, Esq., for the respondent.

The Commissioner has determined deficiencies in petitioners' income taxes as follows:

Year	*Deficiency*
1948	$1,136.79
1949	1,055.70

The deficiency for 1948 is due to the following adjustments:

(a) Disallowed as nontaxable capital gain	$ 1,242.52
(b) Income from sulphur royalty	12,551.00
(c) Net loss not deductible in 1948	2,372.01

Adjustment (b)(1), which is the principal adjustment, is described in the deficiency notice as follows:

> (b) As stated above the amount received for the assignment of a sulphur payment less 23% depletion is included in full in income. See item (d) for reduction of capital gain.

Amount received	$16,300
Less: Depletion, 23%	3,749
Amount taxable	12,551

The petition assigns error only as to adjustment (b) described above. The assignment of error is as follows:

> 4. The commissioner erred in disallowing long term capital gains treatment on the sale of sulphur in place in the ground.

The deficiency for 1949 is based principally upon an adjustment of the same kind and in the same amount as adjustment (b)(1) for 1948, and the assignment of error is the same for 1949 as for 1948. There is also an adjustment for 1949 of $110.67 for disallowance of medical expenses but counsel stated at the hearing that that will be automatically taken care of when we decide the main adjustment in the case.

Findings of Fact

W. F. Wood, sometimes hereinafter referred to as petitioner, resides in Beaumont, Texas. Eleanor M. Wood was petitioner's wife during the tax years 1948 and 1949, and at all other times pertinent hereto. She died testate on August 3, 1952, whereupon, by order of the Probate Court of Jefferson County, Texas, peti-

tioner was appointed independent executor of her estate. He has continued as such to the date of this hearing.

Petitioner and his wife filed joint income tax returns for 1948 and 1949 with the collector of internal revenue, Austin, Texas.

In 1945 and 1946, as principal stockholder, petitioner formed two companies, Pre Fab Building Supply Corporation, and Star Lumber Company, and also formed, as a wholly owned subsidiary of the latter, Planet Lumber Corporation. In 1947, these companies were in need of funds and were not sufficiently sound financially to have adequate credit. In addition, petitioner contemplated the organization of another corporation whose capital requirements would exceed $100,000. Such corporation was actually formed in May 1948, and petitioner did supply most of its capital.

Petitioner in 1947 believed that, in 1948 and the succeeding years, he would need all (or a large part) of the credit which was available to him personally at the banks or through similar sources to obtain funds for use in the carrying on of the aforementioned business enterprises. He therefore desired some assurance that he would have a definite source of funds (other than banks and similar sources) for payment of his individual Federal income taxes due in those later years.

On December 23, 1947, petitioner was the owner of a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land referred to as Boling Dome, in Wharton County, Texas.[1] Petitioner's royalty interest entitled him to re-

[1] The Boling Dome tract was composed of a number of parcels of land. The owners of the royalty interests in sulphur produced from each of those individual parcels entered into a pooling agree-

over $1,000,000 of $2 per long ton of sulphur produced from Boling Dome by the aforementioned companies, irrespective of what the market price for such sulphur might be. Royalty payments were made by the Company monthly, based on the previous month's production. Petitioner's $10,000,000 $2 per long ton interest represented the aggregate of three pooled royalty interests, each in a lesser amount, received by petitioner (a) from his father by two inter vivos deeds dated September 1, 1933, and August 15, 1935, respectively, and (b) after his father's death, from the latter's estate by independent executor's deed dated August 1, 1945. Such interest was not held by petitioner primarily for sale to customers in the ordinary course of his trade or business.

In the summer or early fall of 1947, petitioner, Frank C. Taylor (a C.P.A. then retained as accountant for petitioner's personal affairs and who prepared petitioner's 1947 return), and Marion Munro (a C.P.A. then retained by two of petitioner's corporations and who subsequently prepared petitioner's individual joint returns for 1948 and 1949) discussed the problem of petitioner's business commitments and the need for providing some sure source of funds with which to pay petitioner's individual income taxes, especially those due in January 1948. It was suggested that petitioner might sell a portion of his Boling Dome royalty interest, and Munro expressed the opinion that such a transaction would have the advantage of being taxed to petitioner at capital gain rates. Munro indicated a probable

---

ment pursuant to which royalties from sulphur produced anywhere in Boling Dome were to be distributed pro rata among all such royalty interest holders. This petitioner's interest is referred to as "pooled."

Date	Munro's payments to petitioner	Munro's loans from First National Bank, Beaumont, Texas			
		Amount	Interest	Date paid	Total amt. paid
Dec. 24, 1947	$11,200	$11,000	[illegible]	$ 20.48	$231.31
Sept. 25, 1948	2,000				
Dec. 20, 1948	14,300	[illegible]	[illegible]	[illegible]	95.14
Dec. 19, 1949		[illegible]	[illegible]	2.20.50	18.75
Dec. 23, 1949	16,500				
Total	$46,500	$25,100			$345.74

Munro's loans from the bank were negotiated by him independently of petitioner and were not guaranteed by petitioner. As security for the loans Munro assigned to the bank the royalty interest purchased from petitioner until such time as all of his loans were paid. Coincurrently with that assignment he notified the Texas Gulf Sulphur Company to make his royalty checks payable jointly to himself and the bank and to mail them directly to the bank. The bank credited the royalty checks received first to the principal and interest due on the above loans and, when that was satisfied, to Munro's personal account. Receipt of royalty checks from Texas Gulf Sulphur Company averaging about $2,000 each from February 28, 1948, until March 20, 1950 (on which date the limited royalty interest on 6,000,000 tons was fully paid out), resulted in its being unnecessary for Munro to borrow more than $11,500 in order to meet the two $16,500 notes due petitioner, since Munro was able to pay, in part, those notes at maturity with royalties received and accumulated prior thereto.

As above indicated the limited royalty interest which petitioner assigned Munro on December 24, 1947, was paid out within 28 months thereafter. In his income tax

returns Munro reported the royalties he received as ordinary income, less cost depletion, in the year of receipt.

Petitioner used the $13,900 received from Munro on December 24, 1947, in paying the January 15, 1948, installment on his 1947 Federal income tax.

Separate individual Federal tax returns for 1947 were filed, on a community property basis, by petitioner and his wife. The above transaction was fully disclosed in those returns, was treated as resulting in capital gain, and the profits therefrom were reported on the installment basis. After adjustments for basis and costs of sale, the profit realized in 1947 from the $13,900 received that year was reported as $13,380.78. Fifty per cent thereof, $6,690.39, was taken into account as a community long-term capital gain and petitioner and his wife each reported half of that sum ($3,345.19) as their community share in the separate returns they filed.

Petitioner and his wife filed joint income tax returns for both 1948 and 1949. In each of those years petitioner received from Munro, pursuant to the terms of the aforementioned transaction, $16,300. In their return for each year they reported, after adjusting the $16,300 for basis, a profit of $15,691.11 on the installment basis, and took 50 per cent thereof ($7,845.56) into account as long-term capital gain.

Opinion

Black, *Judge*: Some of the adjustments made by the Commissioner in his determination of the deficiencies are not contested and these adjustments will be given effect in a recomputation under Rule 50.

The issues which we do have before us are common to both years. Petitioner states the issues in his brief as follows:

> 1. Whether the Commissioner erred in taxing to petitioner as ordinary income for the years 1948 and 1949 proceeds from the 1947 sale of a sulphur royalty and whether such proceeds are long term capital gains and properly reported on the installment basis;
>
> 2. If it be determined that petitioner realized ordinary income from the sale of such sulphur royalty, whether all the proceeds should be reported as ordinary income for the year 1947.

The amounts which petitioner has received in each of the taxable years in return for the limited sulphur royalty (hereinafter referred to as a sulphur payment) which he conveyed to Munro in 1947, are not in dispute. Petitioner, in joint returns filed with his wife, returned the profits from those receipts in each taxable year as capital gain on the installment basis. The Commissioner does not question use of the installment basis in returning the income for taxation nor does he question the accuracy of the amounts of the profits reported. He does question petitioner's right to use the capital gain method and has determined that the gain from the conveyance of the sulphur payment is taxable as ordinary income and not as capital gain. That determination is based on the Commissioner's conclusion that the transaction in issue was an assignment of income itself rather than the conveyance of income-producing property.

In support of the treatment of gains from the transaction as capital gains, petitioner cites and relies upon

tioner conveyed merely a fractional part of his interest in sulphur in place (86.254511 per cent of his pooled royalty interest of $0.009956133, that is to say $0.008333333 per long ton on 6,000,000 long tons of sulphur to be produced) and retained not only a reversionary interest in the fraction conveyed (after satisfaction of the sulphur payment therefrom) but a *continuing* interest in sulphur in place to the extent of $0.001328 per long ton produced. Respondent argues, therefore, that the principle applied in those cases is not here applicable.

We fail to see any merit in this argument. Having once determined in the aforementioned cases that the conveyance of a mineral payment constitutes the transfer of property rather than the assignment of income, we see no distinction in carving out that interest in the manner herein employed by petitioner so long as the transaction itself is bona fide. The only particular in which respondent's argument differs from those made by him in the aforementioned cases is as regards the fractioning and, certainly, it is clear that the conveyance of a fractional part of one's interest in income-producing mineral property is not itself regarded by respondent as resulting in tax treatment different from that which would be applicable if the entire interest were conveyed.[3] Moreover, a careful study of the whole record in *Nordan*, as well as in *Wm. Fleming* and *A. J.*

[3] In G.C.M. 12218, XII-2 C.B. 119, respondent stated that a taxpayer's unlimited conveyance, with no retained reversion, of a fraction of his royalty interest (e.g., conveyance in fee of one-eighth of a one-eighth overriding royalty) may be treated as the sale of a capital asset. Similarly, in I.T. 4003, 1950-1 C.B. 10, 11, respondent's apparent position is that the assignment of an oil payment (representing a fraction of the taxpayer's interest but extending over the entire life of the mineral property) may be treated as the sale of a capital asset.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16126

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

versus

P. G. LAKE, INC., RESPONDENT

Petition for Review of Decision of The Tax Court of the United States

(February 1, 1957)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

HUTCHESON, Chief Judge. This appeal by the commissioner from one of a series of adverse decisions[1] of the Tax Court presents the single question whether $600,000 received as consideration for an assignment of overriding oil payment interests limited to $600,000 carved out of two oil and gas leaseholds or working interests[2] is taxable to the seller as ordinary income sub-

[1] Lake v. Commissioner, 24 T.C. 1016; Fleming v. Commissioner, 24 T.C. 818; Wrather v. Commissioner (not officially reported); Wood v. Commissioner, 24 T.C. 1025; and Slagter v. Commissioner, 24 T.C. 934 (7 Cir.).

[2] The respondent is a Delaware corporation with its principal office in Tyler, Texas, engaged in the business of producing oil and gas, and on Dec. 29, 1950, it owned the 7/8 working interest in two commercial oil and gas leases from which it, as the operator, was then, and for several years had been, producing oil in substantial quantities.

On Dec. 29, 1950, respondent was indebted to P. G. Lake in the amount of $600,000, and on that date, in consideration of the can-

ject to depletion rather than, as the Tax Court held, as long term capital gains under Sec. 117 of the 1939 Internal Revenue Code.

Here vigorously assailing the decision of the Tax Court in this and the other cases, on the ground that they were all based on the premise that all oil payment assignments constitute sales of capital assets entitled to capital gains treatment under Sec. 117, and declaring, "That premise was specifically rejected in the Hawn case", the commissioner thus continues:

> "In the present case, as in some of the other appealed cases, the assignor was a leasehold owner which created the oil payment right not just, like the taxpayer in Hawn, the owner of a larger oil

---

cellation of that indebtedness, it sold and transferred to Lake "such an interest in said oil and gas leases * * * so that the said P. G. Lake, Grantee, shall own twenty-five percent of seven-eighths of all oil and gas in, under, or upon such leases and each of them and shall be entitled to receive 25 percent of 7/8 of all the oil, gas and other minerals produced, saved, and marketed from the above described oil and gas leases and leasehold estates, from and after 7:00 a.m., January 1, 1951, until said Grantee, his heirs and assigns, shall have received by virtue of this interest the sum of $600,000 net to him * * *"

The assignment also assured that he should have a royalty owner's status, that is that his 25 percent of the 7/8 of the working interest should be free and clear of any development or production expenses.

It finally provided that after grantee had received the full net sum of $600,000, with interest as provided, from the proceeds of the sale of said 25 percent of 7/8, the conveyance shall terminate and the interest assigned "shall revert to and revest in the grantor, its successors and assigns, and grantee shall execute and deliver an instrument of reconveyance of said interest, and any such other papers as may be necessary to replace the title in grantor".

On Dec. 29, 1950, it could have been estimated with reasonable accuracy that it would require three years or more for the leases to produce oil and gas of the value in amount to which grantee was entitled in the assignment. The actual pay out period was from Jan., 1951, to February, 1954, a little over three years.

payment right. For that reason, the case calls for an even more basic application of the anticipatory assignment of income rule than did Hawn. Not only that, any attempt to treat the oil payment assignment as a 'sale of property according to ordinary property law concepts merely confirms the conclusion that it was an anticipatory assignment of income.

"Our position here in no way conflicts with this court's decision in Caldwell v. Campbell, 218 F(2) 567 where * * * the assigned oil payment rights were carved out of royalty interests * * * ".

Having thus, as he thinks, cleared the ground for an all out and unembarrassed attack on the Tax Court's ruling, the commissioner assails it: (1) as contrary to our decision in Hawn's case in that it treats as substantial an interest which, under the teachings of that decision, is insubstantial; (2) in that what was here transferred was not any part of the leasehold interest, the "property representing income producing property, the vendor's capital investment.", it was a transfer merely of a right to receive future income and, under the teachings of *Burnet* v. *Harmel*, 287 U.S. 22, and the Corn Products case, 350 U.S. 46,[52] it was not entitled to Sec. 117 preferential treatment; (3) in that, if contrary to No. (2) above, the oil payment is treated as a

[52] "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by Sec. 117 applies to transactions in property which are not the normal source of business income. It was intended 'to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' Burnet v. Harmel, 287 U.S. at 106."

sale of income producing property, it had not been held for six months because it did not come into existence until the oil payment was created; and (4) in that the property sold was the oil itself and thus was property "primarily held for sale in the ordinary course of business", and specifically excluded from capital gains treatment.

In reply to these contentions, respondent, insisting that all prerequisites to long term capital gains treatment, if there was a sale of "property" or "real property used in the trade or business" within Sec. 117 I.R.C. of 1939, are here present, urges upon us that whether or not there was such a sale here is ruled by *Ortiz Oil Co.* v. *Commissioner*, 102 F(2) 508 and *Caldwell* v. *Campbell*, 218 F(2) 567, and not by *Commissioner* v. *Hawn*, 231 F(2) 340.

Arguing that the first two cases treat similar transactions to these as sales, that the Hawn case is clearly distinguishable and that petitioner's arguments have heretofore been rejected by this court in *Caldwell* v. *Campbell*, respondent points out that a glance at the table of cases in commissioner's brief and in the brief of Collector Campbell in *Caldwell* v. *Campbell* will show that commissioner's opposing arguments here are but an expanded repetition of those advanced in that case.

Insisting that the transaction under consideration was an assignment of a part of respondent's property interests in the two leases, the respondent cites in support *Commissioner* v. *Fleming*, 82 F(2) 324; *Colorado Oil & Gas Co.* v. *Commissioner*, 118 F(2) 459; *Thomas Peckham Oil Co.* v. *Commissioner*, 115 F(2) 685; *Lee* v. *Commissioner*, 126 F(2) 825; and *Fleming* v. *Campbell*, 205 F (2) 549.

They recall also that the Supreme Court of the United States, this court, the Supreme Court, and the Intermediate Appeal Courts, of Texas[1] have held that oil and gas leases, royalty interests, overriding royalty interests, and oil payments are interests in land, and that the Texas courts have held that these interests are subject to ad valorem taxes, to statute of frauds treatment as real estate, and in cases of intestacy pass as real estate.

On the commissioner's general position that oil payments carved out of working interests differ from royalties so carved, respondent, quoting from *Tennant v. Dunn*, *supra*, at page 290:

> "The interest assigned or conveyed by the instrument is in the nature of an overriding royalty. The assignment gives to Mrs. Dunn, as the reservation of an ordinary overriding royalty gives to or retains in the grantor or assignor, the right to a certain quantity of oil taken from the land, delivered as it is produced, free of charges or expenses of production or operation. * * * It is our opinion that the instrument under consideration conveys an interest in the land * * * "

points to the uniform course of decision that oil payments are in law and in fact of the same nature, indeed are identical, with royalties, except that a royalty is not limited as to duration and an oil payment is.

---

[1] Waggoner Estate v. Wichita County, 273 U.S. 113; Thomas vs. Perkins, 301 U.S. 655; cases cited in footnote 2 (p. 568) of Caldwell v. Campbell, 218 F(2) 565; Sheffield v. Hogg, 124 Tex. 290; 77 SW(2) 1021; Stephens County v. Mid-Kansas Oil & Gas Co., 113 Texas 160; 254 S.W. 290; W. T. Waggoner Estates v. Sigler Oil Co., 118 Texas, 509; 19 SW(2) 27; Tennant v. Dunn, 130 Texas, 285.

To commissioner's third contention that respondent did not have the requisite six months holding period for the oil payment interest conveyed, *a contention on its face requiring the wholly untenable postulate that respondent, in and by the act of conveying the oil payment, acquired it*, respondent points to its complete refutation in the stipulation that *respondent had owned and held the leases for productive use in its trade or business of producing oil and not for sale for several years prior to* Dec. 29, 1950, and to the fact that it is obvious that what respondent conveyed, and the only thing that it could convey, was a part of the estate which it acquired in the acquisition of the leases.

As to his fourth contention, that, in assigning an interest in the leases, *respondent did not assign any part of the property held by it for producing income but assigned merely the oil, the property held for sale in its daily business*, and that this must be *so because the interest of any oil payment owner is only in the oil as personal property*, respondent quotes from the leading case of *Tennant* v. *Dunn*, *supra*, in which, after stating that the particular instrument in question in that case, which carved an oil payment out of a working or lease-hold interest, *did not purport to convey oil in place*, and that the ultimate right of Mrs. Dunn was a right to a certain quantity of oil after it was produced from the well, the same to be delivered to her free from any charges for production or operation, went on to say:

> "*It does not follow, however, that the instrument does not create an interest in land or that it evidences merely a debt to be paid out of oil produced. The oil and gas leases operated to invest the lessee with a determinable fee in the oil and gas in place.*

* * *The instrument above set out under which Mrs. Dunn claims follows the form ordinarily used by a lessee in assigning or conveying an interest in the leasehold estate.* It is not a promise to pay money. *It is not a contract for the sale and delivery of oil, as personalty after production, but it undertakes to invest the assignee, and we think it invests her, presently with a right or interest in what the assignor owned.* * * * *A part of the lessee's right or interest is assigned,* not a fractional interest in the entire leasehold estate but the absolute right, without charges for production or operation, to a fractional part of the oil as and when it is produced from a well on the leased land until the assignee has received oil of the total value of $25,000. *The total quantity of oil to be delivered to the assignee is not a fixed fraction of the entire production and is not a certain number of barrels, but it is measured by value according to a specified standard.* (p. 290) * * * "*The gist of the opinion in Sheffield v. Hogg is that oil and gas royalties, whether payable in kind or in money,* * * * *should be adjudged to be present interests in land rather than merely rights in personalty at some uncertain date, because they are profits arising out of land and further because such classification, which accords with the practice in the oil and gas industry furnishes a stability highly important, if not essential to the structure of the business.* * * * (p. 292.)

"The fact that Mrs. Dunn's purchase of the interest was highly speculative and that she might realize either nothing or very large profits does not affect the nature of the interests. Most invest-

ments in oil properties or production are speculative. Mrs. Dunn did not become by virtue of the assignment a mining partner or a joint adventurer, *for it gave her, not merely a part of the profits of the enterprise, but an interest in land, free of charges for development or operation and without obligation to share in losses;* and under the assignment she had no right to engage, and did not in fact engage, in the operation of the leased land or of the well. * * * " (p. 294) (all emphasis supplied.)

Finally, it is respondent's position that in the light of the views above expressed, this court is bound by the settled law of the cases, including particularly *Ortiz Oil Co.* v. *Commissioner*, 102 F(2) 508; *Fleming* v. *Commissioner*, 205 F(2) 549; *Caldwell* v. *Commissioner*, 218 F(2) 568; and *Commissioner* v. *Hawn*, 231 F(2) 340; and the cases they cite and rely on, to hold that the tax court was right and its judgment must be affirmed.

For the reasons hereafter stated, we find ourselves in complete agreement with these views.

Taking up the grounds put forward by the commissioner for reversal and rejecting, on the stipulated facts, note 2, *supra*, and for the reasons fully stated in *Scofield* v. *O'Connor*, . . . F(2) . . . just decided, the first ground that this court's decision in Hawn's case requires a contrary holding to that made below, we take up to consider in their turn the second, third, and fourth grounds.

These grounds, as we think we shall show, while put forward by the commissioner as presenting new and sound reasons for persisting in his contention that a sale of oil payments is not a sale of capital assets entitled to capital gains treatment, merely give a super-

ficially new look to and faultfully reargue the old contention. This is accomplished by basing the new argument upon a series of unfounded assumptions as to, and the failure to recognize, the already settled state of the law on the matters discussed.

It is, of course, not conclusive against the commissioner's arguments put forward here for the first time in support of his unyieldingly held and persistently urged general contention, that sales of oil payments are not entitled to capital gains treatment, that they have been put forward in this form in no prior litigations or in the Tax Court in the cases under review here.

It is, however, significant that the profound discovery announced and urged for the first time on this appeal, that the sale of an oil payment carved out of a working interest in its legal aspects differs from the sale of an oil payment carved out of an oil interest, has heretofore escaped the attention of judges, lawyers, text writers, and commentators. As far as our information or observation goes, none of the many litigations arising out of or connected with oil payments, none of the decisions, state or federal, dealing with oil payments carved out of a leasehold estate and holding that they are in the nature of overriding royalties, none of the many textbooks, law reviews, or briefs which have dealt with oil payments, have drawn the distinction the commissioner now seeks to draw between oil payments carved out of leasehold interests and those carved out of royalty interests.

This significance is heightened by the fact that the commissioner, as we understand, concedes that overriding royalty interests carved out of working interests or to which working interests are subject are in nowise

different from royalty interests reserved to or granted by the owner of the fee.

In short, a careful consideration of the long and involved arguments put forward in the briefs in these cases in support of the commissioner's new look and view make it plain we think that, *viewed not as proposals for legislation*, in which case wholly different considerations would apply, but as restatements of the law of the decided cases, they rest on demonstrably false premises whose discovery and exposure they cannot survive.

The first of these premises is that the assignment of an oil payment carved out of a leasehold estate is not an assignment of a part of the interest conferred by the lease, a premise precisely refuted in Dunn's case. This premise repeated and affirmed over and over stems from the failure of the commissioner to understand, or his unwillingness to recognize, the nature of such an oil payment, a refusal or failure having nothing to do with the substance and reality of the transaction under review, or with the decisions in point." It arises in

"It does not follow, however, that the instrument does not create an interest in land or that it evidences merely a debt to be paid out of oil produced. The oil and gas leases operated to invest the lessee with a determinable fee in the oil and gas in place. * * * The instrument above set out under which Mrs. Dunn claims follows the form ordinarily used by a lessee in assigning or conveying an interest in the leasehold estate. It is not a promise to pay money. It is not a contract for the sale and delivery of oil, as personalty after production, but it undertakes to invest the assignee, and we think it invests her, presently with a right or interest in what the assignor owned. * * *".

"* * * we have directed attention to the fact that the interest assigned to Mrs. Dunn, if not in principle the same as a royalty, particularly an overriding royalty, is very like it. We believe we may take judicial knowledge of the common practice in the industry as to the method of paying royalties or other interests in oil

short, entirely out of his giving the word "payment" its dictionary meaning where used alone as the satisfaction of a debt or obligation, instead of in the phrase "oil payment" the clearly understood meaning as a part of a technical descriptive phrase used in conveying carved out interests in oil, a meaning which the decisions have ascribed to and fixed for it when used in the connection under consideration here.

An examination of the many cases, federal and state, which have dealt with oil payments, shows that, without varying, the courts have treated alike oil payments whether carved out of the working or the royalty interests, and that the so-called distinction between them, which the commissioner urges here, has never been made before.

It is, we think, completely fallacious to say that an oil payment carved out of a leasehold interest stands any differently in law from an oil payment carved out of a royalty interest, and it is only by the repetition of the incorrect statement, that they do stand differently, that the argument is, or can be, called an argument.

The commissioner's new approach, therefore, that in this case, because the oil payment was carved out of a working interest, there was not a sale of income producing property, a part of the leasehold interest, but merely of oil as personal property after it is produced, is seen to be in complete contradiction of the law of the cases.

Many owners of royalties and like interests have no facilities for receiving oil, and the ordinary practice is that the owners of such interests, whether payable in oil or in money, obtain payment in money after executing division orders to pipe line companies or other purchasers of the oil." Tennant vs. Dunn, 130 Texas, at p. 294.

Equally fallacious is the commissioner's fourth point, that, assuming that he is correct in contending that the sale of the carved out oil payments was not the sale of a capital asset, held for production of income but was an anticipatory sale of the income itself, what respondents sold, though a capital asset, is merely the oil itself, "property held primarily for sale", and therefore, the sale comes within the express exception from Section 117.

In the first place, the Supreme Court of Texas, in *Tennant* v. *Dunn*, *supra*, saying "*It is not a contract for the sale and delivery of oil as personalty after production*, but it undertakes to invest the assignee, and we think it does invest her, presently with a right or interest in what the assignor owned" (emphasis supplied), expressly negatives the commissioner's contention that royalty payments are conveyances of the oil as personalty.

In the second place, it is no more sound to say that the carving out of an oil payment out of a working interest and the sale of the oil payment thus carved is a sale of the oil as personalty, than it is to say that the carving of a royalty out of a working interest and its sale is such a sale, and no one, not even the commissioner, has yet been heard to claim that the carving of a royalty out of a working interest places the owner of the leasehold estate in the position of merely selling the oil itself as personalty and, therefore, that the sale was, within the Sec. 117 exception, of property held primarily for sale. Indeed, the Commissioner concedes that "an oil payment assignment may sometimes constitute the sale of a capital asset as where a person who owns only an oil payment right sells the entire right." Thus, as applied to the case at bar, though

according to the commissioner the taxpayer did not sell Lake a capital asset. Lake somehow acquired one, and if he later sold the whole of what he bought, the purchaser from him would acquire a capital asset, a truly remarkable result.

The commissioner does not enlighten us on whether in the purchaser's hands the oil which Lake would receive from year to year on the wasting capital asset so acquired would be subject to depletion, but we must assume that it would not, since, contrary not to some but to all of the cases on depletion, the commissioner has concluded here that this putative capital asset was depletable in a lump sum in favor of respondent in the year of the sale, even though not a barrel of the oil had been then drawn.

Of the commissioner's third contention, that the sale was not of property held for more than six months, it is sufficient to say that the parties have stipulated, and the facts show, that the properties out of which the interest was carved had been held for more than that time and that the commissioner's contention, that the property sold came into existence with, and only with, its assignment, is contrary to legal principles indeed, is little short of legal legerdemain.

This brings us at last to what in our opinion is the crowning inconsistency of the commissioner's whole argument. This is that the government, through the commissioner, has the right and power to remake or reinterpret their contract for the parties, so that, though, according to the teachings of all the cases,[5] the

[5] Some of these are: Anderson v. Helvering, 319 U.S. 404; Burnet v. Harmel, 287 U.S. 103; Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25; Caldwell v. Campbell, 218 F(2)c 567; Kirby Petroleum Co. v. Commissioner, 326 U.S. 599.

assignee and not the assignor of a mineral interest, under instruments like those here, is entitled to take depletion on it, the commissioner can by his intervention deprive the assignee of his contract right to depletion in the years following and require the assignor to take it all in the year of the sale before the right to it has arisen. Of course, if the instrument transferred an economic interest in the oil, the commissioner cannot do this.

The Court of Appeals for the Seventh Circuit recognized this in the Slagter case in which treating the arrangement there made as a loan and a dedication of the assigned interest in the oil properties to the repayment of that loan, it is held that the assignors were taxable on the transaction not when they obtained the cash paid for the assignment but that the "income in question was taxable as ordinary income of the taxpayers (assignors) as it accumulated and was paid from time to time to Ashland, and that the tax liabilities should be computed for the years in question upon the amounts thus realized and paid to Ashland in the respective periods."

While we incline to the view that, in its opinion in the Slagter case, the Court of Appeals did not give full effect to the true nature of a limited overriding royalty or oil payment interest as announced in *Thomas* v. *Perkins*, 301 U.S. 655, *Anderson* v. *Helvering*, 310 U.S. 404, *Caldwell* v. *Campbell*, *supra*; and numerous other decisions of this court, it is not necessary for us to determine whether the case was or was not correctly decided on its facts. It is sufficient to say of it that nothing said in it or in its result gives any aid or comfort to, or in anywise supports the contention of the commissioner, as applied to the facts

of this case, and that we are of the clear opinion that the decision of the Tax Court was right and should be AFFIRMED.

A True Copy: Teste:

.....

Clerk of the United States Court of Appeals for the Fifth Circuit.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16253

FRANK SCOFIELD, Former Collector of Internal Revenue, APPELLANT

versus

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of THOMAS O'CONNOR, Deceased, and DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, Joined by her husband, D. H. BRAMAN, and THOMAS O'CONNOR, JR., APPELLEES

Appeal from the United States District Court for the Western District of Texas

(February 1, 1957)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

HUTCHESON, *Chief Judge*: One of several appeals[1] from judgments entered in favor of taxpayers, after

[1] Fleming v. Commissioner, 24 T.C. 818; Wrather v. Commissioner, . . . T.C. . . .; Weed v. Commissioner, 24 T.C. 1025; Lake v. Commissioner, 24 T.C. 1016.

Caldwell's case [2] and before Hawn's case [3] had been decided here, this appeal presents the single question whether, in the light of those cases, a transaction involving oil payments carved out of royalty interests was, as claimed by the taxpayer and found by the trial court, a sale of a capital asset, or was, as claimed by the commissioner, an anticipatory assignment of income.

Making no attack upon Caldwell, in fact conceding in oral argument that it was correctly decided, appellant's whole effort is directed to bringing us into agreement with his contentions: that in Hawn's case this court *held* that, though Congress had provided no standard or guide, this and other courts, by the use of a kind of slide rule method not clearly if at all revealed in the decision, could, in their uncontrolled discretion, determine as a fact in each case whether a sale of an oil payment interest is or is not too insubstantial to qualify for capital gains treatment under Section 117; and that, in the exercise of this fact finding power, we should hold as a fact that, because of the insubstantialty of the transaction, the sale made here was not a sale.

It is taxpayer's position: that this court did not in Hawn's case in anywise qualify or limit Caldwell; that it particularly did not hold that, without a legislative standard to guide its decision, it had the power to determine in each case, as a fact, whether an assignment would or would not be regarded as insubstantial; and, finally, that Hawn's case was decided not on the ground of the factual insubstantiality as such of the property purportedly sold, but on the ground that the facts as a whole did not in law show a sale of property at all but only a loan arrangement.

[2] Commissioner v. Caldwell, 218 F(2) 567
[3] Commissioner v. Hawn, 231 F(2) 341.

In support of its view that the court did not intend to lay down any slide rule method of factually determining in each case the insubstantiality of a transfer, but that the case was determined on the ground that, upon its whole facts, what took the form of, was not in fact and in law, a sale, the taxpayer points to the decisive holding of the court:

> "* * * The agreements showed that the parties contemplated using the oil payments over the next two years for the construction of a house for Hawn. * * * The effect was the same as though Hawn had borrowed the funds required, using the oil payments as collateral, and applied the proceeds of such loans to pay the contractor, and then repaid his loans as the oil payments were received. * * *"

So pointing, he urges upon us that since, as was held in that case, there was no sale but only a loan transaction, the court did not, as the commissioner urges it did, establish, or even undertake to establish, a slide rule for determining insubstantiality as to a bona fide sale, which, upon the stipulated facts and the findings of the trial court, the sale in question here was.

It is true that this court, thus properly deprecating the absence of legislative guide or standard:

> "Although it might be better if congress[1] provided the answer, in the absence of a congressional determination, it devolves on the court to supply it."

[1] The Mills Bill, H.R. 9559, dealing prospectively with oil payment sales and related transactions, introduced in the last congress but not passed, illustrates the desirability of legislation to bring about certainty and clarity in this important area of the tax law.

did state that, along with other facts going to the legal effect of the transaction as a whole, the court should determine "whether such transfer is for a substantial interest in the total property owned by the transferor."

It is equally true, however, that it did not undertake to decide the Hawn case on, or in it lay down, any quantitative rule or other guide, fractional or otherwise, for the factual determination by the court in that or any other case as to what would or would not be substantial. Neither did it undertake to hold that if, instead of a fictional or pretended sale, as the court found that the purported sale was, there had been a real sale of an oil payment of $115,000, the court would have been authorized to hold or would have held, that it was insubstantial in amount and, because and only because thereof, it was not a sale.

To the contrary, stating:

> "It is clearly true, as already indicated, that an oil payment like royalty is an interest in property, an interest in realty, and an interest in minerals in place."

and declaring:

> "Deciding, as we do, that not every transfer of oil payments, even for a valuable consideration, amounts to a sale of capital assets under Sec. 117, it becomes necessary for us to determine whether, under the established principles, this transaction was or was not such a sale."

the court went on to say:

> "Upon careful review of the cases and equally careful consideration of the circumstances of this particular transaction, we conclude that this was not such a sale but was rather an assignment of

anticipatory income which remained taxable to the respondent."

This is to say that the court, correctly concluding, on the whole facts, not that there was a bona fide sale which, because in amount it was insubstantial, did not come within Section 117, but that this was not a sale at all, it was a credit arrangement, which, though in form an assignment of the oil interest it purported to deal with, was in fact and in law nothing but an anticipatory assignment of income made as security for, and in payment of, Hawn's debt to the contractor, as correctly *held* that the course of dealings did not amount to a sale or exchange of capital assets under Section 117.

We, therefore, agree with the taxpayer that if, as commissioner contends, this court in the Hawn case did, and we should, without a legislative standard or guide, determine as matter of fact whether and where a time limit was to be drawn upon whether a sale of oil payments was substantial or insubstantial enough to constitute a sale entitling taxpayer to capital gains treatment, the result would be not deciding but mere fiating, or, at best, unwarranted judicial legislation.

If, however, on the other hand, as the Hawn case held and we hold, the court in each case takes all of the facts into consideration for the purpose of determining whether, as matter of law, a transaction was or was not a sale of capital assets, so as to entitle it to capital gains tax treatment under Sec. 117, the court would only be following and applying the rule laid down in the cases, that not every sale of capital assets, but only those which in law come under the statute, will support capital gains treatment,[3] and that it would be running a good princi-

[3] Rudeo Oil & Gas Co. v. United States, 82 Fed. Supp. 746, "a case", as we pointed out in Caldwell v. Campbell, 218 F(2) 570, "of a corporation dealing deviously through its stockholders * * *".

ple into the ground if a taxpayer would be allowed to claim as a sale of capital assets, the daily use of small portions thereof in connection with his business and the payment of his day to day expenses."

That the transaction in this case was not of an insubstantial kind is shown by the fact that it involved a cash sale for $9,990,350 of an oil payment conveying 4,000,000 barrels of oil in place, and by the undisputed facts and the oral testimony of two witnesses, the government's brief stating, "The oral testimony in uncontradicted and accordingly there are no disputed facts".

It is further shown by the definite and precise findings of the district court, which, after setting out the full transaction, categorically and specifically found that the transaction was a bona fide and effective sale.[7]

---

* * * "It was in effect a mere appointment of the stockholders to receive the mineral income of the corporation for sixty or ninety days of the taxable year in which the purported transfer was made. It was therefore a completely abortive attempt, like those dealt with in the Horst, the Harrison and the Eubank cases, to change the statutory rule for the taxation of income by appointing one to collect as his own the income of another."

[6] Cf. what is said by the Supreme Court in Burnet v. Harmel, 287 U.S. 103, argendo and by decision, and in Corn Products Co. v. Commissioner, 350 U.S. at page 52:

"* * * Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by Sec. 117 applies to transactions in property which are not the normal source of business income. It was intended to relieve the taxpayer from * * * excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." Burnet v. Harmel, 287 U.S. at 106."

[7] "Both the sellers and the buyer (D. E. Blackburn) intended the transaction in question to be a sale and purchase of the royalty interests in question. They did not intend to enter into a loan or a mortgage transaction. At no time did the Executors, individually or in their fiduciary capacity, make any guaranty or agree-

Based upon these findings of fact, he concluded as matter of law:

"The transaction with D. E. Blackburn was a bona fide sale.

---

ment to indemnify the purchaser or enter into agreements with the purchaser other than the agreement to sell, as set forth in the deed. At all times, the risks incident to the presence and production of sufficient quantities of oil to make the transaction profitable for the purchaser were upon the purchaser. The purchaser, D. E. Blackburn, borrowed the purchase money from Chase National Bank of New York, giving his note and deed of trust on the properties purchased by him. The bank dealt only with Blackburn and looked only to him. The plaintiffs did not have anything to do with Blackburn's bank loan. The transaction in question was real and bona fide and was, in no sense, a sham or a subterfuge. Blackburn made a substantial profit on the transaction and reported and paid tax on his profit.

"The purpose of the sale of the oil payment was a bona fide business purpose, to-wit, to raise money to pay federal estate taxes and state inheritance taxes due by reason of the death of Thomas O'Connor, deceased, and to pay administration expenses of the Estate. The Estate was in need of cash to correct with which to pay these charges and for these reasons the oil payment was sold.

"The sale in question was the first and only sale of oil payments or other mineral interests that the Estate had made, until that time. Neither the decedent, Thomas O'Connor, nor his Estate, was in the business of selling oil payments or other mineral interest. The limited royalty interests, the oil payment in question, was not held primarily for sale to customers.

"The oil payment 'paid out' after three years of production, during which the properties were owned by Blackburn. The oil payment would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale of the oil payment, which higher price was maintained during the period of the pay-out.

"The royalty interest (or oil payment) sold to Blackburn represented a substantial part of the plaintiffs' oil in place. Also, in terms of the relative values of the interest sold and of the reversionary interest retained by the sellers, the transfer represented a substantial part of the sellers' royalty interest."

"The sale to Blackburn was a sale of a royalty interest in producing oil properties in Texas, subject to a revision to plaintiffs after the royalties had produced in Blackburn's hands the prescribed amount. This was a sale of what is commonly called an oil payment. This oil payment was a real property interest under the law of Texas, and, under the tax laws, a property interest in oil in place. The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. The property so sold was a long-lived, and not a short-lived, oil payment.

"The property interest so sold to Blackburn was a capital asset as defined in Sec. 117 of the Internal Revenue Code of 1939, and this capital asset had been held by plaintiffs for more than six months."

It will serve no useful purpose for us to set out here the undisputed facts on which the findings and conclusions were based. It will be sufficient to say that, on the record made, the district judge was right and his judgment should be AFFIRMED.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Fifth Circuit.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 15981

WM. FLEMING and BESSIE M. FLEMING, (Husband and Wife), F. HOWARD WALSH and MARY D. WALSH, (Husband and Wife) and MARY D. FLEMING WALSH, PETITIONERS,

versus

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

versus

WM. FLEMING and BESSIE M. FLEMING, (Husband and Wife), F. HOWARD WALSH and MARY D. WALSH, (Husband and Wife) and MARY D. FLEMING WALSH, RESPONDENTS.

Petitions for Review of Decisions of The Tax Court of the United States (District of Texas)

(February 1, 1957)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

HUTCHESON, Chief Judge: These consolidated appeals brought by the taxpayers and commissioner, respectively, from decisions of the Tax Court,[1] involve income taxes for 1948 and 1949.

[1] 24 T.C. 818.

Three issues,[2] corresponding to the issues decided below, are presented for review, Issues Nos. 1 and 2 on the taxpayers', and Issue No. 3 on the commissioner's petition.

Submitted on stipulated facts,[3] there were findings in accordance therewith, and a decision against taxpay

[2] These are: (1) The taxpayers exchange limited overriding royalty or oil payment interests (carved by them out of larger oil and gas interests) for, in one case, a ranch; and, in the other, urban business property.

The question is whether the exchanged properties were of "like kind" within the purview of Sec. 112(b)(1) Internal Revenue Code of 1939, so that, all other requirements of said section being met, no taxable gain from the exchanges is to be recognized.

(2) Taxpayer, Mrs. Walsh, in 1943, agreed with a life insurance company that the proceeds of a 10 year endowment life insurance policy on her life, maturing in 1945, "should, after such maturity, be held by the insurance company for an indefinite period of time, not within her control, and, during the first ten years of this extended period, improved with interest, after which interest on the total amount was to be paid to her periodically for the remainder of her life and thereafter as she directed in the agreement.

The question is whether the amounts of the interest improvements in 1948 and 1949, not paid or subject to withdrawal in those years, were nevertheless constructively received during said years by Mr. and Mrs. Walsh "cash basis" taxpayers.

(3) If the first question presented by the taxpayers is decided adversely to them, then should the Tax Court's holding that said exchanges produced long-term capital gain be affirmed, or should the Commissioner be sustained in his contention that the taxpayers merely assigned future income and thereby received ordinary depletable income.

[3] Those pertinent to the first and third issues may be thus summarized:

All of the tax returns involved were filed upon the cash receipt and disbursement basis. Wm. Fleming, the partnership, Fleming Oil Co., Wm. Fleming, Trustee, and F. Howard Walsh, and each of them, were, among other activities, engaged in the business of producing oil and gas. All of the oil and gas properties held by any of those just named and involved in this proceeding had been held by them for several years for productive use in their said trade or business and not for sale.

On May 19, 1948, the Flemings acquired from Mrs. Cline, in the

ers on the two issues appealed by them, and in their favor on the issue appealed by the commissioner.

---

proportions of 50%, 25% and 25% the fee simple title to some 2994.5 acres of ranching land situated in Parker and Tarrant Counties, Texas, and hereafter held said lands for investment and not for sale.

The sole consideration given Mrs. Cline for this ranch was the assignment to her by the Flemings of limited overriding royalty or oil payment interests in various producing oil and gas properties then owned by the respective transferors, and by the terms of the transfer Mrs. Cline became entitled to various fractions of the oil thereafter to be produced from the properties until she had received from the Fleming Oil Company assignment oil of the value of $147,000, from the Wm. Fleming assignment oil of the value of $73,500, from the two Wm. Fleming Trustee assignments oil of the value of $49,000 and $24,500, respectively, plus the same interest factor in all. One of the Trustees' oil *payment assignments was out of leasehold interests, the other out of a royalty interest.*

The assignment from Fleming Oil Co. is typical and only its pertinent terms will be set out. It involved four ordinary commercial oil and gas leaseholds in which Fleming Oil Company was then the owner of an undivided one-half interest; and recited that for a valuable consideration Fleming Oil Company conveyed to Mrs. Cline:

> "The following described real property, to-wit, An overriding royalty or mineral interest carved out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases above described, amounting to an undivided 48/128 interest in and to all of the oil in, under and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering the same, until the grantee above named shall have received therefrom oil of the net value of $147,000, plus an amount equal to 5% interest per annum from May 19, 1948, on the portions of the said $147,000 which may be unsatisfied from time to time."

The instrument further provided that no interest in gas, casinghead gas or in the personal property then on or thereafter placed upon the property was conveyed; that grantee was to be entitled to receive the amount specified from the fractional part of the oil conveyed in addition to such gross production or severance taxes as might be imposed thereupon; that the conveyance was effective June 1, 1948; that all development and operating costs and expenses were to be borne by Fleming Oil Company; and that, when the

On their first question, taxpayers plant themselves firmly on two decisions of this court, *Commissioner* v. *Chrichton*, 122 F (2) 181, holding that a city lot and min

---

grantee had received oil of the net value specified, her interest was to terminate. The instrument also provided:

> "The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom the grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $247,000, plus an amount equal to 3% as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require the grantor to develop and operate said property, in accordance with the terms of the original lease upon said property, as the original lessors therein, their heirs or assigns, might have or exercise".

On Oct. 5, 1949, taxpayer F. Howard Walsh, in accordance with an existing agreement so to do, acquired from one C. C. Cross the fee simple title to revenue producing business real estate located in Fort Worth, Texas, and as the sole consideration for this conveyance, conveyed to Cross a limited overriding royalty or oil payment interest out of some six producing oil and gas leases in which Walsh then owned interests. The conveyance was in terms substantially similar to the terms of the Fleming Oil Company conveyance just summarized and entitled Cross to the specified fractions of oil, when, as and if produced, until he had received, free and clear of all costs and expenses, oil of the value of $65,000, plus an amount equal to interest on monthly declining balances at the rate of 7% per annum. Walsh acquired and has held the aforesaid business property for investment and not for sale. All of the oil and gas leases involved were ordinary commercial oil and gas leases.

The properties acquired by the respective taxpayers in these exchanges had a fair market value equal to the face amount of the respective oil payments conveyed therefor.

It could be estimated at the time the case was submitted to the Tax Court that the oil payment assigned by Fleming Oil Co. would pay out in approximately 5 years and 8 months from its effective date; that from Wm. Fleming, in from 10 to 12 years from its effective date; and each of the oil payments assigned by Wm. Fleming, Trustee, in from 7 to 8 years from their respective dates. Likewise, it could have been estimated that the F. Howard Walsh oil payment would pay out in approximately 3½ years from its effective date.

eral interests, and *Fleming* v. *Campbell*, 205 F(2) 548, holding that oil payments and perpetual mineral or royalty interests, were properties of like kind. Insisting

---

Those pertinent to the second issue are:

The other issue presented involves Mr. and Mrs. Walsh only, and as to this issue the record discloses that on March 28, 1935, Mrs. Walsh (then Mary D. Fleming) acquired from Southwestern Life Ins. Co. a 10 year endowment policy in consideration of ten annual premiums of $2,245.75 each, which were duly paid. The policy provided that if the insured lived to the policy's maturity (March 28, 1945) the insured might within 31 days after such maturity select one of the following options of settlement:

1. $25,000 in cash;
2. $16,400 in cash and a paid up policy for $25,000; or
3. A paid up policy for $72,825.

On September 15, 1943 — some year and a half before the policy matured — Mrs. Walsh entered into an agreement with the insurance company by which, at the maturity of the policy, the payment of the $25,000 proceeds was to be deferred —

"* * * until paid as herein provided:

"Interest on the unpaid portion of such sum at the guaranteed rate of three and one-half per cent per annum, and such additional interest, if any, as may be apportioned thereto by the Company from surplus interest earnings, shall be added to the principal on March 28, each year, until March 28, 1955, and thereafter paid monthly as it accrues, subject to the limitation hereinafter specified, the first payment to be made April 28, 1955. Such interest shall be paid to me, if living, otherwise to the payee or payees as hereinafter designated."

There followed in the agreement provisions for payment after Mrs. Walsh's death to her children and grandchildren, and the instrument concluded —

"It is understood and agreed that the Agreement to be issued and dated March 28, 1945, pursuant to this request, cannot be changed or amended, but the beneficiary may be changed with the consent of William Fleming, my father, upon written request and proper endorsement thereon. All payments provided herein shall be payable at the Home Office of the Company in the City of Dallas, Texas."

In accordance with this, on March 28, 1945, the Life Insurance Company issued an instrument acknowledging the maturity of the policy and that in satisfaction of the obligations of the policy it —

that these cases, holding in accordance with long standing regulations that the statutory phrase "like kind" refers to the nature or character of the property interest and not to its grade or quality, they urge upon us that the exchanged properties, mineral interests for ranch lands in the Fleming transfers and mineral interests for urban real estate in the Walsh transfers, were of like kind.

The tax court judge, though agreeing that the oil payment assignments constituted mineral interests and, therefore, interests in land, was of the opinion that, because the duration of these mineral interests was measured by and limited to oil of the value named in the assignments, the properties exchanged were not of like kind. In short, holding that one was an unlimited, the other a limited, interest in lands, he thought that the sufficient distinction between this and the Crichton case was that the mineral interest exchanged for urban lands there was an unlimited, and not a limited, mineral interest. He thought that the Fleming case could be distinguished because, while it involved a limited mineral interest, a limited overriding royalty

---

"Promises to pay at its Home Office in the City of Dallas, Texas the proceeds of said policy in accordance with the option method of settlement selected by Mary D. Fleming Walsh, the insured, in writing, a photostatic copy of such election being hereto attached and made a part hereof."

Nothing was paid to Mrs. Walsh, or anyone else, by the insurance company under said settlement agreement, during the years 1948 and 1949, and Mr. and Mrs. Walsh reported no income from that source in those years. But in determining the deficiencies due by Mr. and Mrs. Walsh for 1948 and 1949 the Commissioner treated as interest income constructively received by them $2,132.18 and $2,206.81, respectively; these amounts being the amounts added to the principal due under the interest provision above quoted from the settlement agreement.

or oil payment, the exchange there was of that interest solely for undivided fractional oil, gas and other mineral interests. To which the taxpayers reply that if, as was held in the Chrichton case, the exchange of an unlimited mineral interest for urban property was an exchange of like kind and in the Fleming case that an exchange of limited, for unlimited, mineral interests was also an exchange of like kind, it must follow, upon the principle that things equal to the same thing are equal to each other, that any of the properties involved in the two exchanges, if exchanged for any involved in the other, would result in exchanges of like kind.

On this issue, Judge Borah dissenting, we agree with taxpayers.

In *Commissioner* v. *Chrichton*, 122 F(2) 181, we pointed out that the invoked section, 112 (b)(1), is so general in its terms as to render an interpretative regulation appropriate and that the Treasury regulation invoked and sought to be applied was appropriate and valid.

In *Fleming* v. *Campbell*, 205 F(2d) at p. 549, quoting in the margin from the Chrichton case,[1] we rejected the argument of the collector "that the mineral interest in the Ector County lands was an interest in fee and that in the Gregg County lands, for which it was exchanged, was a leasehold of a fee which does not have thirty or

---

[1] * * * * the regulation and the interpretation under it, leave in no doubt that no gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use." Com. v. Crichton, 121 F(2) at p. 182.

more years to run, and that, therefore, under the regulation the interests exchanged were not of like kind", saying:

> "We cannot agree. In the first place, both interests exchanged were interests in land, (citing in note 5 many cases). In the second place, neither interest was a 'leasehold of a fee' in the sense in which that term is used in the regulation. Both were interests in minerals in place. Both were therefore interests in land, interests not in personal but in real property, in short, real rights."

We are, therefore, of the opinion that, in those two cases, this court, in principle, decided the question presented here, and that, upon the authority of those decisions, the judgment of the tax court on the first issue must be reversed.

If we assume that we are in error in this view, and we, therefore, reach the third issue, note 2, *supra*, raised on the commissioner's appeal, that the tax court erred in holding that the transactions were exchanges of property giving rise to capital gains treatment and not anticipatory assignments of income, we find ourselves in agreement with the tax court, and, for the reasons set out in *Scofield* v. *O'Connor* and *Lake* v. *Commissioner*, this day decided, we affirm its judgment on this issue.

We come then to a consideration of the taxpayers' second issue, raised by the Walsh appeal, that the tax court erred in holding that the amounts added in 1948 and 1949 under the amended contract with the insurance company, though not paid to taxpayers in those years, were subject to taxpayers' withdrawal and

therefore, constructively received: The tax court, stating:

> "Petitioner [Mrs. Walsh] has deliberately turned her back on income, and has in effect selected the year in which she will report it. This she may not do. Further, the whole arrangement for the nonacceptance of income was voluntary on petitioner's part, she was in no way forced to surrender her right to the proceeds of the matured policy, and she could have had the interest paid to her currently as she did in the second agreement."

concluded:

> "Petitioner, a cash basis taxpayer, cannot escape income tax by directing that accrued interest be accumulated for her benefit in the future. See Theodore R. Bayard, 16 T.C. 1345. * * * "

Here taxpayers insist that the commissioner and the tax court misunderstand the nature and effect of Mrs. Walsh's agreement and the law applicable thereto. Pointing out that under a valid and binding agreement made some eighteen months before the maturity of the policy and effecting a novation of the original agreement, the parties changed the terms of their contract, the taxpayers, citing *Commissioner* v. *Oates*, 207 F(2) 711 as precisely in point, insist that the commissioner and the court are undertaking to make for parties, who were competent to make and had made a valid agreement, an agreement that they did not make.

Pointing to the difference between the facts of this case and those dealt with in our case of *Williams* v. *United States*, 219 F(2) 523; that there the taxpayer

gained nothing by his agreement for the voluntary escrow of moneys admittedly due and payable to him, except, if the plan was successful, a reduction of his taxes and that this court correctly held that moneys so voluntarily escrowed by him were constructively received by him in the year of the escrow; whereas, in this case, there was a real contract in which both contracting parties obtained benefits; taxpayers insist that the Williams case is not against, but is in support of, their contention.

We agree with taxpayers' contention. In the Williams case, the district judge and this court held that the transaction was not an installment sale but a completed one, the gain from which was immediately available and, therefore, taxable, to the seller in the year of its making, and the taxpayer could not, by voluntarily escrowing the purchase price under an agreement that he should receive it in installments, defer payment of the taxes due on the sale.

There is nothing in this record indicating anything other than arms length business transactions between Mrs. Walsh and the company, a contract maturing in 1945, and an agreement entered into eighteen months before its maturity by which, instead of receiving the whole sum in 1945, she agreed with the company that it would hold the funds until 1955, another ten years, adding to the principal amount each year interest at an agreed figure plus such additional amounts as might be appropriated each year from the life insurance company's excess earnings. As a result of the agreement, the amount of the interest added to the principal in 1948 and 1949 was greatly in excess of the guaranteed rate of $3\frac{1}{2}$ percent. In short, in 1943, when her new

contract was made, Mrs. Walsh contracted for a greater rate than would have otherwise been available to her if she had continued to receive only current interest payments. In the years before this court, 1948 and 1949, Mrs. Walsh not only received nothing, she had no right to receive anything.

The judgment against taxpayers on this issue must be reversed.

The judgment of the tax court is AFFIRMED on the commissioner's appeal. On the taxpayers' appeal, it is REVERSED and the cause is REMANDED for tax redetermination in accordance herewith.

Judge Borah dissents from the decision on the first issue note 2 *supra*.

A True Copy. Teste:

Clerk of the United States Court of Appeals for the Tenth Circuit.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16055

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

versus

JOHN WRATHER and NELL WRATHER, Husband and Wife, RESPONDENTS

Petition for Review of Decision of The Tax Court of the United States (District of Texas)

(February 1, 1957)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges

HUTCHESON, Chief Judge: This appeal from an unreported decision of the Tax Court on stipulated facts,[1]

[1] Briefly and adequately stated, they are:

In 1948 the George & Wrather Drilling Company, a partnership, of which the taxpayer, John Wrather, was a member, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc. (hereinafter called COOP) three oil payments carved out of their interests in two oil and gas leases which had been held by the partnership for more than six months. One was for $130,000, payable out of 9/10 of 7/24 of 7/8 of all of the oil produced and saved from the Brown Lease; the others were for $155,000 and $12,500, respectively, payable out of 9/10 of 5/16 of 7/8 of all of the oil produced and saved from the Kieffer "A" Lease.

As consideration for these assignments, COOP paid the partnership $287,500 cash which was treated by the partners on their tax returns as gain from the sale of capital assets. The oil payment out of the Brown Lease paid out in a period of 4 years and the oil payments out of the Kieffer "A" Lease paid out in a period of 5 years, 5 months.

and findings by the Tax Court in favor of respondents, presents the single question whether the Tax Court erred in holding that taxpayer John Wrather's share of the proceeds received from the sale by a partnership, of which he was a member, of oil payments carved out of leasehold estates owned and operated by it was long term capital gain under Sec. 117, rather than ordinary income subject to depletion.

Here the commissioner advances the same contentions and arguments which, at greater length, he advanced in *Commissioner* v. *Lake* and *Fleming* v. *Commissioner*, this day decided, while the respondents here oppose to them substantially the same contentions and arguments advanced by the respondents in those cases.

Referring to, without restating the considerations upon, and the reasons for, which, rejecting the commissioner's, and sustaining the taxpayer's, contentions, we conclude that those cases had been correctly decided below, it is sufficient for us to hold that, upon those same considerations and for the same reasons, we conclude that this case was correctly decided and that the decision and order appealed from should be AFFIRMED.

A True Copy. Teste:

Clerk of the United States Court of Appeals for the Fifth Circuit.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16105

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

versus

W. F. WEED, INDIVIDUAL, AND ESTATE OF ELEANOR M. WEED, DECEASED, W. F. WEED, EXECUTOR, RESPONDENTS.

Petition for Review of Decision of The Tax Court of the United States (District of Texas).

(February 1, 1957.)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

HUTCHESON, Chief Judge: This appeal is from a decision of the Tax Court, 24 T.C. 1025, holding that gain resulting from taxpayer's sale and transfer of a sulphur payment carved out of his pooled royalty was taxable as long term capital gain.

It presents the single question whether the proceeds received by taxpayer from the transfer of a sulphur payment carved out of his $.0096613 per long ton pooled royalty interest, which he had owned for years, consisting of approximately 86 percent thereof, effective until the assignee shall have received 6,000,000 long tons of sulphur and no longer, which was expected to pay out within four years but actually paid out in 28 months, constituted ordinary income subject to de-

pletion rather than, as the Tax Court held, capital gain under 1939 Code, Sec. 117.

Here, contending that this case is clearly controlled by, and requires the same result as that reached in, *Commissioner* v. *Hawn*, 231 F(2) 340, and urging that the transfer of a sulphur payment carved out of royalty has no better status than the transfer of an oil payment so carved, the commissioner insists that the transfer was not effective as a sale of capital assets because it was not of a substantial part of the total property owned by taxpayer assignor.

The taxpayer, pointing out that the Texas courts have determined that mineral payment rights in Texas are real property interest [1] and that that view has been consistently held by the Texas Courts, appropriate United States Courts of Appeals,[2] and the United States Supreme Court, which, in *Thomas* v. *Perkins*, 301 U.S. 655, determined the nature of an oil payment for income tax purposes and established the rule that an oil payment creates an economic interest in the mineral in place, insists that under the undisputed facts of this case,[3] fully set out in the opinion of the Tax Court, to which reference is here made, the transaction

---

[1] Sheffield v. Hogg, 24 Tex. 290, Tennant v. Dunn, 130 Texas, 285; A. W. Walker, Jr., "Oil Payments", 20 Texas Law Review, p. 259.

[2] Lee v. Commissioner, 126 F(2) 825; Fleming v. Campbell, 205 F(2) 549; Ortiz Oil Co. v. Commissioner, 102 F(2) 508; to which may be added Caldwell v. Campbell, 218 F(2) 567 and Commissioner v. Hawn, 231 F(2) 340.

[3] Briefly summarized, these are:

Dec. 23, 1947, taxpayer Weed owned a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a sulphur deposit in Wharton County, Texas, known as Boling

constituted the bona fide and effective sale of a substantial mineral interest entitling it to capital gains treatment.

Upon the considerations advanced by the Tax Court and for the reasons set out by us in *Scofield* v.

Dome; this interest entitled him to receive $.00966133 per long ton of sulphur produced

At the same time taxpayer was supplying funds and credit for a number of companies of which he was principal stockholder, and anticipated he would need all of the bank credit available to him for these enterprises. Further, he realized that, in addition, he needed a definite source of funds for payment of his individual federal income taxes.

In the fall of 1947, taxpayer negotiated with Munro for the realization of these funds, and transferred to Munro 86.254514% of taxpayer's pooled royalty interest of $.00966133 (i.e. $.0083333) per long ton on six million tons of Boling Dome sulphur in exchange for $13,900.00 cash and two notes of $16,300.00 each; the six million tons of sulphur were produced 28 months thereafter.

The taxpayer disclosed the transaction fully in his 1947 tax return, treating the proceeds as capital gains and reporting the profits on the installment basis. Taxpayer's 1948 and 1949 returns reported the $16,300 received from Munro for each such year as long term capital gain. The Commissioner determined that the 1948 and 1949 payments were taxable as ordinary income, subject to depletion. The Tax Court held these proceeds were realized from the sale of a sulphur payment and constituted capital gain.

The following are the pertinent portions of the assignment:

"I, W. F. Weed, in consideration of [$13,900 cash and the two $16,300 notes] * * * do hereby SELL, TRANSFER, and ASSIGN, unto the said Marion F. Munro, * * * 86.254514% of $.00966133 per long ton pooled royalty on sulphur produced by Texas Gulf Sulphur Company at Boling Dome, Wharton County, Texas, from lands and premises described in said above named conveyances [to petitioner from his father and his father's estate] until 6,000,000 long tons of sulphur have been produced and accounted for to the said Marion F. Munro therefrom, which royalty so sold and here assigned and conveyed amounts to $.0083333 per long ton.

* * * * * * * * *

"This assignment and the royalty transferred and assigned hereby on sulphur produced from Boling Dome * * * shall continue to be effective until said Marion F. Munro shall have received said royalty on 6,000,000 long tons of sulphur and no longer.

O'Connor, this day decided, we agree with the respondents and with the Tax Court that the gain in question constituted not ordinary income subject to depletion but capital gain.

The Tax Court's decision is therefore AFFIRMED.

A True Copy. Teste:

Clerk of the United States Court of Appeals for the Fifth Circuit.

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 16126

COMMISSIONER OF INTERNAL REVENUE

versus

P. P. LAKE, INC.

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of the said Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 16253

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE,

versus

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of THOMAS O'CONNOR, Deceased, and DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, Joined by her Husband, D. H. BRAMAN, and THOMAS O'CONNOR, JR.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 15981

WM. FLEMING and BESSIE M. FLEMING, (Husband and Wife), F. HOWARD WALSH and MARY D. WALSH, (Husband and Wife) and MARY D. FLEMING WALSH,

versus

COMMISSIONER OF INTERNAL REVENUE

COMMISSIONER OF INTERNAL REVENUE

versus

WM. FLEMING and BESSIE M. FLEMING, (Husband and Wife), F. HOWARD WALSH and MARY D. WALSH, (Husband and Wife) and MARY D. FLEMING WALSH.

This cause came on to be heard on the petitions of Wm. Fleming and Bessie M. Fleming (Husband and Wife) and F. Howard Walsh and Mary D. Walsh, (Husband and Wife) and Mary D. Fleming Walsh, and Commissioner of Internal Revenue for a review of decisions of The Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the judgment of the said Tax Court on the Commissioner's appeal in this cause be, and the same is hereby, affirmed; and on the Taxpayers' appeal, that said judgment be, and it is hereby, reversed; and the cause is remanded to the said Tax Court for tax redetermination in accordance with the opinion of this Court.

"BORAH, Circuit Judge, dissents from the decision on the first issue note 2 supra."

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 16055

COMMISSIONER OF INTERNAL REVENUE

versus

JOHN WRATHER and NELL WRATHER
Husband and Wife.

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of The Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision and order of the said Tax Court appealed from in this cause be, and the same is hereby, affirmed.

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 16105

COMMISSIONER OF INTERNAL REVENUE

versus

W. F. WEED, INDIVIDUAL, AND ESTATE OF ELEANOR M. WEED, DECEASED, W. F. WEED, Executor

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a

decision of the said Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.